CHINA'S FINANCIAL SYSTEM AND MONETARY POLICIES: THE IMPACT ON U.S.EXCHANGE RATES, CAPITAL MARKETS AND INTEREST RATES

TUESDAY, AUGUST 22, 2006

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, D.C.

The Commission met in the Room 385, Russell Senate Office Building, Washington, D.C. at 10:07 a.m., Vice Chairman Carolyn Bartholomew and Chairman Larry Wortzel and Commissioner Patrick A. Mulloy (Hearing Cochairs), presiding.

OPENING REMARKS OF COMMISSONER PATRICK A. MULLOY HEARING COCHAIR

HEARING COCHAIR MULLOY: Good morning. My name is Patrick Mulloy. I'm a commissioner on the U.S.-China Economic and Security Review Commission, and I'm very pleased to have the opportunity to cochair today's important hearing with Larry Wortzel, who is the chairman of our Commission, and I appreciate his courtesy in asking me to open the hearing.

In this hearing, we will seek to assess the condition of the Chinese financial system, and that's important because we're told that China can't float its currency because it has so many problems in its financial system. We want to look at the status of China's compliance with its WTO obligations in the financial services area, and we want to look at the relationship between China's financial system and its one-party political system which is run by the Communist Party.

In this hearing, we also hope to explore the nature of the capital flows in and out of China, China's exchange rate policies and how such capital flows and exchange rates impact the U.S. economy and the lives of our citizens.

The Chinese policy of keeping its currency undervalued has contributed to our nation's vast and growing trade deficits with that country. Last year, our trade deficit with China exceeded 200 billion. This year, it will likely be around 240 billion. These large and growing trade deficits have, in turn, helped China accumulate foreign currency reserves that will this year exceed $1 trillion.

Now, China invests much of its foreign currency reserves in U.S. Treasury bills and other U.S. government debt instruments. Why? This helps China manage the undervaluation of its currency, but it also permits our country to have lower interest rates than we might have otherwise.

Now, among other things, this permits Americans to take out home equity loans to continue buying Chinese goods--like GMAC financing. It also encourages distortions in the U.S. economy such as an over investment in housing, a lack of savings, and an under investment in manufacturing firms affected by Chinese imports.

In addition, China earns new dollars as Americans pay China dollar interest on the increasing amount of our government debt. In other words, they buy U.S. government Treasury bills. Of course, we have to pay interest. So that money is flowing from us to China.

Our nation, in the words of Tennessee Ernie Ford's immortal 1955 song entitled "Sixteen Tons," is, quote, "another day older and deeper in debt."

The Commission invited the Treasury Department, which has expertise on these matters, to testify today. But unfortunately, that department declined our invitation. Over the five-year life of this Commission, many members of Congress, including committee chairmen, and many departments and agencies of the executive branch, such as the U.S. Trade Representative and the Departments of State, Commerce, Energy, Agriculture and Defense, have testified before this Commission a number of times. This has helped the Commission capture their views in our reports to Congress.

The Treasury Department despite a number of invitations has never appeared. It seems that department has not wanted to explain and be questioned on how it is exercising its enormous responsibilities regarding U.S.-China economic and trade relations. We have reason to believe and we are very hopeful that this situation will change under Secretary Paulson's leadership.

We are very fortunate to have a number of top experts here as our witnesses today and we appreciate very much them taking time to be with us. I thank them for their presence and look forward to their testimony.

Let me now turn the hearing over to Chairman Wortzel who will introduce our first panel of witnesses.

[The statement follows:]

Prepared Statement of Commissioner Patrick A. Mulloy
Hearing Cochair

I am very pleased to have the opportunity to co-chair today's important hearing with Larry Wortzel, the Chairman of our Commission. In this hearing, we will seek to assess the condition of the Chinese financial system, the status of China's compliance with its WTO obligations in financial services, and the relationship between China's financial system and its one party political system, which is run by the Communist party.

The Commission will also explore in this hearing the nature of capital flows in and out of China, China's exchange rate policies, and how such capital flows and exchange rate policies impact the U.S. economy and the lives of our citizens.

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China invests much of its foreign currency reserves in U.S. treasury bills and other U.S. government debt instruments. This helps China manage the undervaluation of its currency and also permits our country to have lower interest rates. Among other things this permits Americans to take out home equity loans to continue buying Chinese goods. It also encourages distortions in the U.S. economy such as an over investment in housing, a lack of savings, and under investment in manufacturing firms affected by Chinese imports. In addition, China earns new dollars as Americans pay China dollar interest on the increasing amounts of our government debt they hold. Our nation, in the words of Tennessee Ernie Ford's 1955 song entitled Sixteen Tons, is "another day older and deeper in debt."

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OPENING STATEMENT OF CHAIRMAN LARRY WORTZEL, HEARING COCHAIR

CHAIRMAN WORTZEL: Good morning, ladies and gentlemen. In many ways, the Chinese financial system is still a black box that operates in some pretty mysterious ways. Our goals in holding the hearing are to understand how that system operates, to assess the relationship between the informal financial system and the formal banking system, to explore how the financial system is run by the Communist Party, and to explain how these things affect the United States.

At our last hearing, former Assistant Secretary of State Karl Jackson suggested that China's foreign reserves might equal the amount of non-performing loans held by China's banks. According to the Asia Times this week, those foreign reserves now total $940 billion.

Despite efforts to make the loan process in China's banks more transparent, according to Chinese figures, outstanding payments are up over 16 percent in the first six months of the year. With American banks seeking partnership with Chinese banks, the question is: how can American investors be sure that their deposits are not being used to bet in a giant shell game in which only the Chinese Communist Party knows under which shell the pea, or the money, is--in other words, which bank is solvent?

According to yesterday's Wall Street Journal, the Huntsman Corporation of Woodland, Texas will retrench in the United States and look to invest in China, where it anticipates a billion dollars in revenue. But if the Chinese yuan doesn't trade on the open market, how does Huntsman get its money out of China? What premium is there to let that money trade? How does it move around or is it just staying there and being reinvested?

Today, we have a number of experts who will address these and other questions today. In the first panel, you're going to hear from Mr. Gordon Chang, Mr. Michael Petit, and Dr. Kellee Tsai. They will address the condition of China's financial system.

Gordon Chang is the author of The Coming Collapse of China, published by Random House in 2001. He worked in China and Hong Kong for two decades, and he's been associated with the law firms of Paul Weiss and Baker & McKenzie.

His expertise has been sought by major universities and think tanks in the U.S., by the U.S. government, and he often appears in the media, so we're very happy to have him here today.

Mr. Michael Petit is Managing Director for Asia-Pacific Corporate and Government Ratings for Standard and Poor's, where he's worked since 1987. Before that, he was a credit analyst and corporate lending officer at a commercial bank. He has an MBA from NYU's Stern Business School and a Master's degree in Economics from the University of Paris.

Dr. Kellee Tsai is an Assistant Professor of Political Science at Johns Hopkins University. She has a Ph.D. in Political Science from Columbia University, and she is the author of Back-Alley Banking:

Private Entrepreneurs in China. She's also co-authored another book on Rural Industrialization and Informal Finance in China and has edited other books and articles. She's worked at Morgan Stanley and at the World Bank.

One of the reasons we're interested in this informal economy is ten percent of China's population is in the floating population of China. Workers just move from place to place and do day labor. They find work in one place and move to another. That's ten percent of the population that's probably outside the formal economy. So it's a very important subject.

For the panelists, each of you will get seven minutes for your oral testimony. Your written testimony will be part of the full record. There are a set of lights up here that will direct you to talk, sum up, and stop. When it turns red, please wrap it up, and then each commissioner in a round of questions will have five minutes each.

We'll go with the order in which I introduced the panelists. Gordon, you're up.

[The statement follows:]

Prepared Statement of Chairman Larry M. Wortzel

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Dr. Kellee Tsai is an Assistant Professor of political science at Johns Hopkins University. She has a Ph.D. in political science from Columbia University. She is the author of "Back-Alley Banking: Private Entrepreneurs in China," has co-authored another book on rural industrialization and informal finance in China, and has edited other books and articles. She has also worked at Morgan Stanley and the World Bank.

PANEL I: THE CONDITION OF CHINA'S FINANCIAL SYSTEM

STATEMENT OF GORDON G. CHANG, AUTHOR, BEDMINSTER, NEW JERSEY

MR. CHANG: Chairman Wortzel, Chairman Mulloy and distinguished members of the Commission, thank you for the opportunity to be here today.

I believe that the Chinese economy is heading for turmoil. Why? Because there's too much debt. Chinese leaders have stuffed debt into all levels of the government, into central government instrumentalities, into state banks, and into state enterprises. We know that Beijing is concerned about the problem because it actively tries to hide the amount of its indebtedness.

Official figures claim that the central government had the equivalent of US$409 billion in debt at the end of last year. And of this amount, $281 billion was denominated in foreign currency. China's total sovereign indebtedness was 18 percent of gross domestic product at the end of last year, and that's generally well below the alarm level of 60 percent.

China's announced government debt is not only modest but it's also well structured in that much of it is in its own currency and is long-term. If there were to be a financial crisis in China--let me rephrase that--when there is a financial crisis in China, the value of its renminbi debt as expressed in foreign currency will undoubtedly decline.

So it doesn't look like there is much of a problem, but of course this is not the end of the story. There are substantial obligations that China does not include in its published figures including central government debt that is incurred for municipal and local projects, Ministry of Finance guarantees related to partial bank recapitalizations, debt extended by multilateral institutions and by other governments, borrowings by China's four policy banks, miscellaneous obligations such as those related to grain subsidy payments, and debt of enterprises that produce revenue flows that feed into the central government budget. And by this, I mean primarily enterprises that are managed by the People's Liberation Army.

Unfortunately, China is increasingly relying on off-balance sheet financing which means that China is becoming even less transparent. To help improve this transparency, let's just list some other hidden obligations such as the unrecorded debt of local governments, non-performing loans in the state banks, non-performing loans on the books of the asset management companies and the central bank itself, debt of state-owned enterprises, and of course pension and social welfare obligations.

China's debt-to-GDP ratio is not 18 percent as Beijing claims; it's closer to 81 percent. In coming up with this 81 percent ratio, I excluded more than half of China's debt because I felt that this debt really wasn't relevant to a debt crisis scenario. But if you add all of this debt together, you come up with a ratio that approaches 160 percent, which is what Morgan Stanley has done. No matter how you calculate this ratio, China has too much debt especially for an economy that could be one rumor away from disintegration.

Now many analysts say that China's foreign exchange reserves, which as Chairman Wortzel mentioned was $941 billion, and now the largest in the world, will prevent a debt crisis, but I think that's wrong. As a practical matter, foreign currency reserves can only be used to pay off foreign currency debt. But China doesn't have a foreign currency debt problem. It has a domestic debt problem.

It is true that China could use its foreign currency reserves to buy renminbi to pay off local debt, but that would send the value of the currency soaring, and that of course would choke off the critical export sector and of course Beijing is not going to do anything to choke off exports because that would eventually affect the economy as a whole.

The reserves would be useful in a debt crisis if the government were to dollarize the economy. But for various reasons, that will not happen because it cannot happen. When China has a debt crisis, it probably will be triggered by its insolvent banks which are getting weaker over time, not better. We should note that the United States suffered a severe banking crisis, not to mention one of the worst downturns in its history, when Washington held the world's largest reserves of gold, francs and sterling.

So having reserves is not a vaccine for a debt crisis. The problem for China is that the underlying conditions necessary for a debt crisis exist today. And history shows that in a debt crisis everything goes wrong at the same time. So the issue is, is this crisis going to affect us? American and global markets are deep and flexible and can handle just about everything.

I think that even if Beijing were to dump all of its treasuries at the same time, it probably would only take one or two quarters for the markets to return to normal. The real risk China poses is not so much the severity of a financial crisis, but it's the unexpected nature of one.

Now, there may be very little that we can do to avert a financial crisis in China because the Chinese government despite receiving a lot of good advice from everyone is not really doing enough to reduce its debt. But public discussion of China's precarious position would at least give market participants the opportunity to take a future crisis into account now, thereby making future market adjustments less painful in the future.

In short, the more we discuss the possibility of financial turmoil in China, the better off we will be. Market participants don't talk about problems until it's too late, and when it happens, they talk about nothing else. We should do a lot better with regard to China.

Thank you very much.

[The statement follows:]

Prepared Statement of Gordon G. Chang, Author[1]
Bedminster, New Jersey

CHAIRMAN WORTZEL: Thank you. Mr. Petit.

STATEMENT OF MICHAEL PETIT, MANAGING DIRECTOR STANDARD & POOR'S ASIA-PACIFIC CORPORATE & GOVERNMENT RATINGS, TOKYO, JAPAN

MR. PETIT: Thank you very much. Mr. Chairman, members of the Commission, good morning. My name is Michael Petit. I'm Managing Director in charge of Standard and Poor's Corporate and Government Ratings in Asia-Pacific. I welcome this opportunity to appear before this Commission and discuss China's banking sector.

China has made meaningful progress in strengthening its banking system over the past few years. To start, the government has purchased non-performing loans through asset management companies to reduce the burden of problem loans. The government has also demonstrated its clear commitment to reforming the banking sector by means of

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1 Click here to read the prepared statement of Gordon G. Chang

improving the regulatory system and introducing better risk management systems and controls.

The government has also encouraged the participation of foreign banks and the ownership and the management of local institutions so as to bring in new technologies and share best practices.

Notwithstanding the great strides achieved to date, China's banking system remains weak by global standards. It lags almost all other developed and major developing markets in terms of asset quality, risk management, internal controls, corporate government and financial strength.

The most visible weakness of China's banking system is the extent of its problem loans which S&P estimates to represent about 20 to 25 percent of total credits, or an amount equivalent to 500 to US$650 billion.

We include special mention loans in our estimate of problem assets, as these are likely to fall into the non-performing loan category if the business environment were to deteriorate markedly. And given the exceptionally strong business environment that China is now enjoying, this large amount of special mention loans is striking and of particular concern.

Poor asset quality is only the most readily apparent of the financial weaknesses afflicting Chinese banks. Weak profitability and capitalization are others. Low profitability inhibits the bank's ability to adequately provision for the inevitable percentage of loans that go bad, and weak capital levels are insufficient to soak up eventual write-offs of problem loans.

This weak banking system impacts China negatively, chiefly in two ways. One, it places a huge contingent fiscal liability on the government, as the banking system on its own is not able to cope with the likely emergence of more problem loans, and, second, it fails to allocate capital efficiently and thus to contribute to a more balanced development of China's economy.

Altogether, the government has spent an estimated US$400 billion equivalent to support its banking system since 1998, and with its steadily increasing fiscal revenue and exceptionally strong external position, the government has the flexibility to undertake operations of a similar magnitude if needed.

So while the government's resources and supportive stance mean that the integrity of the banking system is not under threat, the true cost of China's weak banking system is in its misallocation of capital and poor contribution to economic growth.

However paradoxical this may sound in an economy that has averaged over eight percent growth in the past decade, the reality is that Chinese banks have contributed little to the development of the non-state sector of the Chinese economy, which has been the main engine of GDP growth and employment.

To tackle its banking problems, China's government is using a combination of both direct and indirect tools, ranging from the outright purchase of problem loans to the strengthening of regulatory oversight and control.

It is also in a measured way encouraging foreign banks to invest in local institutions as a means to import international expertise and to instill industry best practices.

China in conclusion clearly has the will to reform. The progress it has made in placing China's banks on a commercial footing is material and irreversible. The capital of the large banks is being opened. NPLs have been cut. Recapitalizations have been carried out. Many state-owned enterprises have been reformed or closed and the extent of government-directed lending has been reduced.

From an outsider's perspective, the pace of these reforms may seem sluggish and their outcome uneven. But given both the dominance of the banking system within the overall financial system and the weakness of the banking system, the risks that China faces in setting down a liberalizing path are in making a misstep.

Its reform program needs to be carefully coordinated and sequenced to avoid any unwanted disruption to its economic system.

Thank you.

[The statement follows:]

Prepared Statement of Michael Petit, Managing Director Standard & Poor's Asia-Pacific Corporate & Government Ratings, Tokyo, Japan[2]

CHAIRMAN WORTZEL: Thank you very much. Dr. Tsai.

STATEMENT OF DR. KELLEE S. TSAI ASSOCIATE PROFESSOR OF POLITICAL SCIENCE JOHNS HOPKINS UNIVERSITY, BALTIMORE, MARYLAND

DR. TSAI: Yes. I'm an Associate Professor of Political Science at Johns Hopkins University. Recently tenured.

CHAIRMAN WORTZEL: Congratulations. That's a big milestone.

DR. TSAI: It is. I want to thank the commissioners for including

[2] Click here to read the prepared statement of Michael Petit

me on this panel. My comments today are going to focus on the relationship between informal finance and private sector development because my first book, Back-Alley Banking: Private Entrepreneurs in China, was motivated by the question of how China's private sector has gone from being virtually non-existent in the late 1970s to generating nearly half of its GDP today.

As of mid-2006, less than one percent of all loans extended by state banks were going to private entrepreneurs, according to official statistics. Less than one percent. So the puzzle that motivated my first research project was where are entrepreneurs getting the money to run their businesses?

The short answer to this question is that the private sector has relied on a variety of informal financing mechanisms ranging from basic interpersonal credit and loans and trade credit to more sophisticated self-enforcing rotating credit and savings associations that have written contracts that specify multi-tiered interest rates and deposit schedules. And then there are private money houses and underground banks, which are disguised as different types of organizations such as magazine reading clubs and old folks associations.

Technically speaking, the dividing line between legal and illegal forms of informal finance is that those involving interest rates above the state-mandated interest rate ceilings are not sanctioned. So, for example, interest-free lending among merchants is generally acceptable, but by definition loan sharks generally charge interest rates that are well above the interest rate ceilings, and with the exception of Minsheng Bank and two micro-finance experiments, private commercial banks and private money houses are illegal.

But, in reality, most forms of informal finance that private entrepreneurs use fall into the realm of quasi-legality, meaning that there are many financial institutions that are not sanctioned by the People's Bank of China but are legally registered by another government agency within China.

A good example of this is the rural cooperative foundations, which were established by the Ministry of Agriculture to provide grassroots credit to farmers in the late 1970s, and from their inception, the People's Bank of China always opposed them, never recognized them as legitimate financial institutions, and yet they thrived and grew and really became a very important source of credit for farmers. Eventually, the People's Bank of China succeeded in shutting them down or merging with them the rural credit cooperatives in 1999.

Another example of quasi-legal financial institutions that are still operating are the mutual assistance societies and cooperative savings foundations, and they're registered with the Civil Affairs Bureau as nonprofit organizations that are meant to help the poor, but in reality, they extend loans to private enterprises and offer high interest rates on savings deposits. Some also help the poor, but a lot of them are for profit as well.

There are also other deceptive ways of raising capital such as registering as a collective enterprise when you're really a private enterprise. This is called wearing a "red hat" because red symbolizes communism.

In my survey of private entrepreneurs, over 70 percent of the respondents admitted to using some form of informal finance, and in my book, I estimated that up to three-quarters of all private financial transactions in China are occurring outside of the formal financial system.

The People's Bank of China did a more recent national survey on informal finance and estimated that the annual scale of informal lending is about US$118 billion or almost seven percent of China's GDP.

One point I'd like to emphasize is that there's considerable diversity and local variation in the scale and the volume of informal financing mechanisms throughout the country.

First, rural areas face much more credit constraints since state banks have consolidated their branches in rural areas and rural cooperative foundations were shut down in 1999. One Chinese economist estimates that 300 billion renminbi in saving deposits is flowing out of rural areas, and into urban areas annually.

Second, localities that have more developed non-state sectors also have more vibrant curb markets because there is simply a highly demand for credit in those areas.

And third, local governments have very different attitudes toward private sector development and informal finance. In localities where there are very large state sectors and collective sectors, the local cadres are less tolerant of informal finance. They tend to be somewhat less supportive of private sector development as well.

But in localities where the economy is dominated by private businesses, local governments are often protective of the private entrepreneurs' creative and sometimes illegal financial activities. When they are not actively protective, then at least they look the other way most of the time.

The People's Bank of China and the China Banking Regulatory Commission is well aware of the fact that the private sector relies heavily on informal finance. The People's Bank has done research on this issue. They've launched repeated campaigns to shut down underground banks and other types of informal finance, but it's proven to be a losing battle. They generally find another way to reappear.

Meanwhile, Beijing has also implemented various reforms and experimental measures to increase the private sector's access to formal sources of credit. While these efforts are steps in the right direction for commercializing China's banking system and allocating credit in a much more market-oriented manner, I'd like to wrap up by pointing out that such measures will never completely eliminate informal finance because there are strong economic, fiscal and personal incentives at the local level for cadres to protect these curb market operators, and even if the supply of bank credit and micro-credit increases in localities that need it the most, it may not reach the intended market because local social and economic elites may distort the intended allocation of credit.

In short, informal finance is rampant in China and it's likely to be around for a long time even if the formal financial sector becomes a lot more efficient.

Thank you.

[The statement follows:]

Prepared Statement of Dr. Kellee S. Tsai
Associate Professor of Political Science
Johns Hopkins University, Baltimore, Maryland[3]

Panel I: Discussion, Questions and Answers

CHAIRMAN WORTZEL: Thank you very much. I know a number of the commissioners have questions for you. Commissioner Blumenthal, I guess we'll start with you.

COMMISSIONER BLUMENTHAL: Yes. Thank you all very much for your testimony. This is primarily to Mr. Chang, but I'd like all of you to take a stab at it, and it's this question of implications for the United States of some sort of collapse or banking crisis. As Commissioner Wortzel pointed out, we heard testimony from Professor Karl Jackson about the shock and surprise of the Asian financial crisis that actually brought down the Suharto government and the United States and other entities had to respond in some measure, and I'm wondering. My question is twofold.

One is if you could spin out for us what would a collapse or banking crisis look like, the various sectors in China that would be hit most hard, and also what you think the American and other financial institutions would be asked to do at that point, as well as you've said, Mr. Chang, that it really wouldn't be of that much consequence to us because after a couple quarters markets would return. But if you could

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[3] Click here for the prepared statement of Dr. Kellee Tsai

just spin out which market participants, United States' market participants, would be most affected?

But I'd like to get the question, I'd like to spin out a scenario whereby the Chinese banking sector collapsed and is causing massive political upheaval and we're actually asked to respond in some measure. If all of you could take a stab at that with Mr. Chang first.

MR. CHANG: I think the problem is that if there were to be some problem with the banks, and there could easily be because bank runs have occurred in China for the silliest of reasons, what you probably would have is an economy where the banks would start to hoard liquidity. In other words, they wouldn't be lending for either massive projects or for small consumer loans, and I'd see the economy tending to contract, and probably it could contract quite quickly given the fact that a number of factors that we've all talked about would occur.

In terms of what would happen inside China, I think the export sector might actually not be affected as much because if we look back, for instance, at the turmoil in China during the Beijing spring of 1989, the export sector just continued to hum along as if it were in a separate country, but the problem I think would be felt in the state sector which, although it represents a declining portion of GDP, does represent a bulk of the Chinese economy in terms of employment and other things. So I think that the effect would still be substantial.

In terms of what we would be expected to do, I don't think that there is really that much we could do because as we saw in 1997, as you've referred to, and in other financial crises in the past, these things happen very quickly, and I'm not sure that the central government would have the wherewithal to think about exactly what would happen and what they would ask foreigners to do.

I think it would be very difficult politically for them to ask Americans for any sort of help, and I don't think that we would really be at a point where we'd be thinking about that because we don't really think about financial crises in China. We see this large country that is eating up us in terms of all the things that Chairman Mulloy talked about.

So I think that essentially the Chinese are going to be pretty much on their own when these things happen, and we're going to really just be on the sidelines. To answer one specific point, I think that if the Chinese government were to start to dump treasuries, people worry about what would happen to our country.

In a sense, if they dump treasuries, they're probably going to buy euros and yen, which would send those currencies soaring, which means the Japanese and the Europeans would probably have to buy treasuries to keep their currencies in line. So I tend to see that the financial impact on the United States really would be quite limited. Therefore I tend to think that in all of this, things would go quite quickly.

COMMISSIONER BLUMENTHAL: Just to follow up on that, in terms of social upheaval in China, you say the state sector would be affected. Are we talking big layoffs? Are we talking a government that all of a sudden has to deal with even more stresses to its system? What sort of scenarios do you see there?

MR. CHANG: I see people in a contraction where credit isn't being extended, a lot of these state enterprises have been kept going through what are generally termed "evergreen" loans. They're just continually rolled over. I'm not sure that in a liquidity crisis, the Chinese banks would be able to do that. So you would have, as you point out, the layoffs and the other manifestations of an economic contraction, but I think this would happen. In a sense, you would see all the classic signs of deterioration in an economy, and it could go slowly, but I tend to think it might go a little bit quicker.

But we would see, for instance, people just not paying back their car loans. They're not paying back car loans now, and in a contraction there is certainly going to be less incentive for them to honor their obligations to the banks.

COMMISSIONER BLUMENTHAL: Does anyone else?

HEARING COCHAIR MULLOY: If Mr. Petit or Dr. Tsai, if they have a quick comment they want to make to your question, why don't we let them do that.

MR. PETIT: I would just like to say that a collapse of the banking system is not really in the cards. The banking system is extremely weak, but it has been improving. To go along with the scenario, though, of some difficulties in the banking system, I think it would come from an acceleration of NPLs which would cause some excess capacity in some sectors and deflationary pressures. As Mr. Chang pointed out, that would cause new loans to reduce and a contraction of GDP.

I don't think that would be good for the U.S. economy or for the global economy. China over the past ten years has accounted for something like one-third of global GDP growth (that's worldwide), so a contraction of China's economy would not be beneficial to anyone. There could be some positive impact in terms of reduced commodity prices, but that would be very secondary.

HEARING COCHAIR MULLOY: Doctor.

DR. TSAI: Yes. I'd like to echo Mr. Petit's assessment that a complete collapse of the banking system is very unlikely, but compared to the state of China's financial system in 1997-1998 when the Asian financial crisis was going on, it is in much better shape now. The Asian financial crisis really frightened Beijing, and it's taken numerous efforts to strengthen the banking system, and it's been gradual, but it has been happening. So it's in much better shape.

Having said that, there have been localized financial crises, and they're usually triggered by the threat of banking regulators coming down to close down these informal financial intermediaries which makes people go for runs on banks because they think everything is going to be closed down. So a lot of it is actually generated internally by China's own banking regulators and they now realize that as well.

As far as problems, there are problems in the banking system, and if one of the Big Four failed for whatever reasons, yes, that would have repercussions, and, yes, it would primarily affect the state sector, as Mr. Chang pointed out.

But one thing I wanted to highlight is that the state sector is much, much smaller than it was even in 1997. According to the OECD, the private sector now generates nearly two-thirds of the GDP, and as far as the people who would really be hurt in terms of the inability of state banks to continue extending loans to the SOEs, only 14 percent of China's workforce is now covered by state-funded pensions--14--1-4. That's tiny. It's not the Mao era anymore.

And also there are still 85 million workers employed under the state system, but that's only one-third of the urban workforce. So I just want to emphasize that the scale of the state sector is much smaller now.

HEARING COCHAIR MULLOY: Thank you all for your comments on that. Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you very much, Mr. Chairman, and thank the panel for coming and presenting very interesting testimony on a subject that this Commission has been looking at for many years. As I recall, one of our first witnesses at our first hearing was Dr. Chang to talk about the question of the collapse of the Chinese banking system.

Putting aside the question of collapse, this is a question for Dr. Chang and Mr. Petit, but Dr. Tsai, if you're interested, you may comment, too.

My question is the requirements of the WTO Accession Agreement as of this December will require that China open up its financial system to more outside scrutiny and investment, a degree of market liberalization, whose scope and speed has only been seen in the case of Russia and Central European countries. The result in Russia was the development of a gangland kind of system. Central Europe did a little bit better.

But to what extent is China going to be under strain and the system will be under strain in terms of the risks that it's going to be taking to comply with its WTO Accession Agreement this December--or will it not be able to comply with it? Will it be increasingly out of compliance and what risks would it entail if it were in fact to fully comply with those requirements in its WTO Accession Agreement?

MR. CHANG: I think that Beijing has given us a hint that it's going to certainly drag its feet in terms of permitting foreign banks to have national treatment, which is essentially what WTO requires. For instance, in the last week and a half, Beijing has been talking about requiring foreign banks to incorporate locally and also to have very high capitalization requirements for those local banks owned by foreigners.

I think that, of course, they can take a long time to drag this out, but essentially at some point, they will have to come into compliance. The problem really for the Chinese banks is a very simple one. I acknowledge that they have better computers now and they have some better procedures, but we are now talking about non-performing loans today in the hundreds of billions of dollars, perhaps $911 billion according to the Ernst & Young withdrawn report, perhaps a trillion, which is what I think is more likely, maybe even just $650 billion, which is the Standard and Poor's number.

Nonetheless, we're talking about a very substantial amount of money and just economic reality says that these government banks are going to have a hard time in terms of competing.

Foreign banks don't have to compete with local banks across the board in order to pose a threat to the Chinese banking system. You have to remember that Chinese banks are insolvent, and the only reason why they continue is because they're liquid, and all the foreign banks have to do is siphon off the best customers and liquidity to have a real problem.

Of course, we have not had a Chinese banking collapse since I've been here last time, but nonetheless, we are dealing now with a system which has larger and larger amounts of NPLs. The Chinese have been reforming, but the banks have been getting weaker, and that's a paradox. And sometime there has got to be a confrontation with reality in China, and WTO, I think, is going to be one of those triggers.

COMMISSIONER D'AMATO: Mr. Petit.

MR. PETIT: I would say that post-December 2006 when China will fully accede to WTO won't result in any significant changes. I think China by and large has been in compliance with the letter of the WTO requirements. In December of this year, foreign banks should be allowed to do local currency business, deposit-taking, lending operations, across the nation, but right now they're allowed to do it in 25 of the most affluent cities in the country. So that won't make much of a change.

That being said, there will be continued restrictions to the ability of foreign banks to operate. For example, branch openings, and there will be probably continued heavy requirements on the capitalizations of branches; and the need to incorporate their operations locally. But to sum up, I don't think there's going to be much of a difference from the situation now.

COMMISSIONER D'AMATO: Thank you. Did you have a comment on that?

DR. TSAI: I'll just add a very minor comment, which is that the 17th Party Congress is coming up this fall, and I think a lot of the official discourse leading up to the 17th Party Congress should be taken with a grain of salt because of the economic nationalism going on in the country, but once the current leadership consolidates its power or it changes in the 17th Party Congress, then we can see what will happen, and that's all I'll say for now.

COMMISSIONER D'AMATO: Thank you.

HEARING COCHAIR MULLOY: Thank you. Commissioner Wessel.

COMMISSIONER WESSEL: Thank you to all our witnesses. Mr. Chang, it’s good to have you back before us again. We appreciate all the advice and counsel you've given over the years we've been in operation.

Mr. Petit, I was wondering if you could give us a little information on how S&P does ratings as it relates to China? Do you rate the country as a whole? Do you rate individual entities? We've seen a number of Chinese banks seek to access foreign capital markets. How does your rating system approach all of that and what is the current rating of China's market if you do that as a whole?

MR. PETIT: Thank you. Yes, we do have a rating on the country as a whole. That's our sovereign rating, which we upgraded about a month ago. The rating now is A, stable, which is the same rating as we have on Korea, for example, so it's a fairly strong rating. We also have credit ratings on about 45 individual businesses: financial institutions and mostly corporates. Many of these are incorporated in Hong Kong, but have most of their operations in mainland China.

The way we operate in China is fairly typical of our operations elsewhere except that we have some restrictions in our ability to have analysts in China. A lot of our work is done out of Hong Kong and our other offices throughout the region.

COMMISSIONER WESSEL: Do the Chinese companies use GAAP accounting and other internationally accepted standards? You indicate you have some access issues. How different is the access to information and knowledge that we have about these entities?

MR. PETIT: In general, the transparency is extremely poor. The companies that we rate typically are listed in Hong Kong so their accounting systems are pretty clean. They're based on IFRS.

COMMISSIONER WESSEL: So if they are seeking to access--my understanding, for example, is Goldman has taken positions in the financial sector and has actually invested in a number of banking institutions and has taken some of the NPLs, discounted them. How does that affect investors here who may be in Goldman Sachs' stock or any other entity that's investing there? I'm not trying to single out Goldman.

In terms of information, is there a derivative ability to have better information because we have U.S. companies doing business there or are they flying blind in a lot of ways?

MR. PETIT: Those institutions like Goldman Sachs, HSBC, that take significant investments in these institutions, have to do extremely intensive due diligence because the transparency in those institutions until they list is very poor.

COMMISSIONER WESSEL: So when they list, are we seeing enhanced rights of disclosure, enhanced access? Is the participation of our banks and foreign banks helping China move towards a better banking system and should we be spurring that on? What kind of risk or benefit does that pose?

MR. PETIT: The participation of international investors in the capital, the ownership, and the management of Chinese financial institutions is very beneficial. It does add to transparency. It improves their corporate management practices. Typically they bring in new technology, lending practices. So it is very beneficial.

I'd like to add that the amount of investments of institutions like Goldman and ICBC are relatively small compared to the capital base of these institutions, so they're not taking any risks on behalf of their investors.

COMMISSIONER WESSEL: Mr. Chang, did you have any comments? Dr. Tsai?

MR. CHANG: The last comment I think is certainly right. Just given the depth of these institutions, I don't think that we're really getting very much, though, when a major institution invests into a Big Four bank. We've had these investments in the Big Four banks and than all of a sudden the Chinese government decides to change all the presidents of these banks, which happened about six weeks ago, and they've continued to do so.

So, even though foreign money is coming in, we're not changing the mentality of the Chinese government and all the time the NPLs are going up. I can remember seven, eight years ago, I was saying there was $600 billion of bad debt in the banking system, and people were looking at me like I was crazy, and now the most conservative estimate is over $600 billion, and we're talking perhaps something like a trillion.

So this is getting worse over time especially as the Chinese banks blow up their systems. Although, yes, foreign institutions do help a little bit, this whole process is like a runaway train, and so it's almost irrelevant to what we can do to help these institutions improve.

COMMISSIONER WESSEL: Dr. Tsai, any comment?

DR. TSAI: No.

COMMISSIONER WESSEL: Thank you.

CHAIRMAN WORTZEL: Commissioner Donnelly.

COMMISSIONER DONNELLY: Thank you, Mr. Chairman, and thanks to the witnesses. I'm interested in better understanding the phenomenon of non-performing, special mention, and other bad loans. I suppose I'd like to get a real big one myself. But I wish you could tell me in particular about the political dimension of this.

To begin at the beginning, the official figures look like things have improved pretty well, almost suspiciously well. Cutting the rate in half in a couple of years must be a pretty good performance, if true. So again I'd like to get your assessment as to how much faith we put in the official figures?

Secondly, I'd like to know who's continuing to get these, whether there's a political dimension to that? Particularly, what the state of play is with PLA enterprises? Are they likely to be recipients of continuing bad loans?

Lastly, what happens when the government disposes of these things? Do they just go on to another ledger? Presumably if the loans are terminated and liquidated, you'd see some effects in the sense of companies going out of business and social dislocation because of that.

Do we have an audit trail that follows even a particular loan through non-performing status to disposal by the government, and then some company that is shut down as a result therefore, so what happens to these things when they are allegedly taken care of by the government?

MR. CHANG: I think we have to put some time perspective on this. Around 1996-97, the governor of the central bank at the time said that China's bad loans were at one or two percent. Then they got to be a little bit more realistic, but now they've cut down their estimates to essentially $150 billion or about eight percent for the largest banks.

That just doesn't seem reasonable because we know that, for instance, in the first six months of this year, Chinese banks increased their lending by 10.38 percent over the end of 2005. Even in a well-regulated environment with a strong lending culture, no bank can blow up its balance sheet at the rate of 20, 22, 23 percent a year and still avoid bad debt. So we know that things are very bad in China, much worse, I think, than the institutions at this table would be willing to admit.

Where do these loans go? China has been moving them on to the asset management companies, on to the books of the central bank, which we don't know very much about, but we do know that about a year ago in August, the central government created an asset management company for the central bank itself, which confirmed rumors that there were real problems with the asset management company loans that had been transferred to places we hadn't seen including the central bank.

What we have gone is from one institution, from the state enterprises, the problem has been moved to the state banks, to the state asset management companies, to the central bank itself, and now to an asset management company for the central bank. So there really is, I guess you could call it, a shell game, but certainly they haven't really solved very many of their problems, especially even when we consider that they've sold about $100 billion of these bad loans to foreign institutions, it's not clear that the foreign institutions have taken 100 percent credit risk for the loans that were allegedly sold.

These look more like contingency collection procedures. So there's a real problem, and it's not going away. And that's why the figures are getting bigger all the time.

MR. PETIT: Just to add a few details. The official amount of NPLs at the end of 2005 was nine percent. We believe it's closer to 20 to 25 percent because the official number doesn't include special mention loans which are likely--in more difficult business circumstances--to go bad, and it doesn't include bad loans in the policy banks and in the rural cooperatives.

I think the interesting political dimension to these NPLs is that most of them arose from conflicts of interest. The PBOC itself did a survey last year showing that close to 80 percent of NPLs were the result of conflicts of interest where local governments were owners of some of the banks and financed unnecessary projects.

Where do these NPLs go? They don't disappear. Asset management companies, which are 100 percent government owned, take them over. The bankruptcy insolvency laws are poor, so they are difficult to dispose of. And that's why we consider these problem loans whether they're with the banks or the government to be contingent fiscal costs on the government.

DR. TSAI: You get three different people; you'll get three different NPL figures. The China Banking Regulatory Commission yesterday posted on its Web site that as of the end of June--this is official statistics--the NPL for all commercial banks had dropped to 7.5 percent, and then they divided it up into state-owned commercial banks--it was 9.5 percent. Shareholding banks, NPLs of 3.1 percent. Rural commercial banks, 6.6 percent. City commercial banks, 6.7 percent. And foreign banks, 0.9 percent.

Anyway, I agree. Those are vast underestimates because they don't include the special mention loans, the high risk loans, and that's the only thing I really wanted to highlight, is that the nature of NPLs has shifted from really subsidizing the state sector, paying for pensions, keeping people employed, to now financing often extravagant real estate projects, sometimes perhaps viable ones too, but there's clearly been overinvestment in fixed asset investment, and this is something that the center is trying to rein in, but it's having extreme difficulty doing because local cadres have an incentive to build these fancy projects for professional promotion purposes. So there's an internal incentive problem within China.

COMMISSIONER DONNELLY: If I may just ask, do we have any insight on the extent of PLA enterprises--

DR. TSAI: Oh, yes, I wanted to address that, too. Actually, as you probably know, James Mulvenon is the person for that because he's written a book about the rise and fall of the military industrial complex. Basically, as you probably know, the PLA was forced to divest all of its investments in 1998.

Now, it took a few years for this to actually happen, but now officially state banks cannot be extending soft loans to PLA enterprises. This is not legal. So if it's happening, it's happening completely illegally. So you can't look at their balance sheets and see any loans going to PLA enterprises which traditionally only had numbers like the No. 245 tractor factory or whatever.

CHAIRMAN WORTZEL: Chairman Bartholomew.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you very much and thank you to all of our witnesses for very interesting testimony. I have a couple of questions. The first one has to do with these special mention loans. What are they?

MR. PETIT: The CBRC introduced a loan classification system in 2003 which is modeled on the loan classification systems of most other countries. So it's a five category system. Special mention loans are the second best loan category. The definition is a little bit rough, but they are supposed to be loans that are expected to be performing or are still performing normally, but the borrower appears weak, and caution should be there, and banks should set aside a certain amount of reserves for these special mention loans.

COMMISSION VICE CHAIR BARTHOLOMEW: Do we have any belief that those loans might be loans that are managed by the Communist Party for political reasons or to calm unrest in certain places?

MR. PETIT: These loans really run the gamut. Most of the loans within the banking system are extended to state enterprises--some of them. Those that would be classified as special mention loans would be almost by definition very weak state owned enterprises.

COMMISSION VICE CHAIR BARTHOLOMEW: Gordon, did you have a comment?

MR. CHANG: To just follow up on what Dr. Tsai said, because of the big fiscal stimulus that is powering the state economy, fixed asset investment was increasing about 30 percent a year, and although the government has been trying to stop it, it hasn't really been.

So what you have in reality is a lot of this fiscal stimulus is the showcase projects, and essentially local governments have been responsible for much of the creation of essentially useless projects. Some of them do have some use, but they're not economically viable and they certainly wouldn't receive credit if there were no political backing.

Those types of projects which we see across China, probably many of them fall into the special mention category because for one reason or another, the banks don't have, for instance, good security over the land or the real estate improvements or whatever. So I think this is an emerging problem, even more so than the loans to the state enterprises.

This is something which we should be watching, and there is a certain amount of Communist Party direction, but it's not direction at the top of the political system. It's direction at the bottom of the political system where the local cadres want to build this enormous project. For instance, in my father's hometown, the most magnificent building is the Communist Party Headquarters, which is absolutely beautiful amid the wreckage of this town. I'm sure that local banks were forced to extend money for this magnificent municipal project.

COMMISSION VICE CHAIR BARTHOLOMEW: So in light of an official lending system that's corrupted by any number of reasons or interests, talk a little bit more, Dr. Tsai, about this curb market. What are the upsides of it? What are the downsides of it? Does it essentially function more rationally than the official lending system?

DR. TSAI: Yes. The upside is that it operates in a more market-oriented manner. The people who are financial entrepreneurs, they're out there to make money, and so they'll charge interest rates according to, you know, their risk evaluations of their potential clients. They know them. They're more creative in terms of the type of collateral that they may accept, but they actually do their research much better.

The downside is that not all the people that are involved in the curb market are well trained or very well educated. Some aren't even very good at math sometimes though. For the most part they're pretty good. So there are occasional crises and then sometimes local people's savings deposits are lost or they mutate into pyramid investment schemes like Ponzi schemes, so there are these kind of perverse effects, and that's why they really do need to be regulated, and the People's Bank of China recognizes that.

MR. CHANG: If I may add, the curb market has the best enforcers in China.

DR. TSAI: Oh, yes, yes.

MR. CHANG: So there's an added dimension to why they're so good.

DR. TSAI: Yes, assets will be confiscated. Fingers will be taken, kids will be kidnapped. You name it, they get their loans back. They have very low NPL rates. Very low.

CHAIRMAN WORTZEL: Commissioner Thompson.

COMMISSIONER THOMPSON: Thank you. You mentioned that the state banking system is still a minimal source of loans to the non-state sector.

DR. TSAI: Officially, yes.

COMMISSIONER THOMPSON: And even that the government has clamped down on these non-state lending sources. I was wondering what their thinking is? Is this situation and the promotion of this situation by the government simply a means to control the growth of the non-state sector? You would think there would be some beneficial things to the growth of a healthy market.

DR. TSAI: It's not that there's a central government strategy to try to rein in the growth of the non-state sector. To the contrary, I think they're pretty happy to the extent that it's rational investment and not in real estate.

COMMISSIONER THOMPSON: Then why do they make it so difficult to finance it?

DR. TSAI: The problem is that the banking system itself is separate from the rest of the government as well. The banking system was revived at the beginning of the reform era to start extending loans to state banks. Before, SOEs were just getting money straight from the government budget, and then starting in the reform era, it started to be funneled through the state banking system.

These state banks were originally set up to serve the SOEs, not to serve the non-state sector, and so all the employees within the state banking system were afraid to lend to private entrepreneurs because they thought, well, if they don't repay, I could lose my job, it would be disastrous. They also weren't trained to evaluate clients according to standard market criteria for evaluating creditworthiness. They weren't looking at their credit history and collateral.

They were saying, oh, it's a local SOE and the manager just said if you don't give me this loan, we're going to have 10,000 people on the streets. So that's why. It has to do with the way that the state banking system has been set up and is now trying to evolve. Thus, even though state credit managers and state banks are now encouraged to extend commercially viable loans, they're still experiencing a lot of local, political pressure to extend loans for these real estate projects even though their careers may be on the lines.

COMMISSIONER THOMPSON: Even though the loans that they are in making in many, many cases are non-performing--

DR. TSAI: It's actually--yes.

COMMISSIONER THOMPSON: --I guess if the borrower is well connected, it's still a safer loan than--

DR. TSAI: Right. There's something a little bit perverse too about the incentives that credit managers and bank officers have been given. Between 1998 and 2002, the credit officers were very reluctant to extend new loans because their jobs were directly evaluated on the reduction of bad loans, but then starting in 2002, they were rewarded for reducing the NPL ratio.

The NPL ratio is calculated according to the number of NPLs and the total loans outstanding. To reduce that ratio, credit officers tried to increase the denominator of that ratio, which is total loans outstanding. So now they're extending more loans to make the ratio go down so that they will get a bigger raise the next year.

COMMISSIONER THOMPSON: Gentlemen, do you have any comments?

MR. PETIT: I would only add that there is really nothing to this except that the credit risk assessment capabilities in the banks, particularly at the branch level, are very limited. So it is easier and the perception is that it's safer to lend to an SOE, to a local government-related project, than to a private company.

COMMISSIONER THOMPSON: Thank you.

CHAIRMAN WORTZEL: I have a question about non-bank financing. Also, I have to admit that my direct experience with the People's Liberation Army is somewhat dated, but in my experience, PLA units or People's Armed Police or Public Security Bureau actually financed enterprises, defense exhibitions, hotels or bars or other forms of less reputable entertainment. The money that came from these things came from illegal sources such as smuggling or these less reputable forms of entertainment.

These profits then went out to private enterprises. So I'm very familiar with Mulvenon's work on the formal structure of PLA units helping out their own budgets. Is that still going on?

DR. TSAI: I haven't seen that as much. When I was doing my research in the early to mid-1990s from around 1993 through '98, and '98 is sort of the real critical year that things started to change, yes, I did see the less reputable forms of business in smuggling that you were referring to, and perhaps there were PLA connections in some spots, but more recently like my research since 2001, I really haven't seen it.

If it's happening, then it's really underground. I haven't heard of people talking about it.

CHAIRMAN WORTZEL: Thank you.

MR. CHANG: Could I just mention, my bar-hopping research will tell you that the best Vietnamese restaurant--

CHAIRMAN WORTZEL: Good research.

MR. CHANG: --the best Vietnamese restaurant in Shanghai is technically owned by a retired Air Force officer, but everybody in town knew that this really was an Air Force establishment, and because of that, it had a better clientele than most other restaurants in town. It had all the black limousines in front and I'm sure that the money was being funneled not to the private retired officer but up to the PLA.

This I think is very hard to research so you're not going to see it. But if you just talk to people, you will see that this economy, which the PLA is not supposed to have, as you pointed out, certainly does still exist.

CHAIRMAN WORTZEL: I had a beer in such a bar in Beijing a month ago. So it does go on. Commissioner Reinsch.

COMMISSIONER REINSCH: Yes. One thing occurred to me as Commissioner Thompson was talking. Can any of you, and perhaps, Mr. Petit, you might be the best one, compare the points you made about the Chinese banking system to that of India? How does it stack up? How does the Indian system stack up? I guess what I'm trying to get at, are the problems you're discussing unique to China either in their nature or their magnitude or are they endemic in rapidly growing economies?

MR. PETIT: It's an interesting question. Most of the Indian banking system is also owned by the government, but the Indian banks have much better risk assessment capabilities and much better asset quality and capitalization. I think it just comes from their longer experience in making loans on a commercial basis even though they also have directives from the government to make a certain amount of loans to priority sectors, for example, which typically are the source of most of their problem loans.

But the banking system in India is by and large of better quality and more efficient in terms of allocating capital. It's also smaller within the overall financial system. There are better functioning equity markets and securities markets in India.

Another difference is that even though the maximum ownership of foreign institutions of Indian banks is five percent versus a cumulative 25 percent in China, the influence of foreign investors in Indian banks is probably a bit stronger than in China. They have been able to put in place more of their own expertise there and they have a better, a greater share of the total assets in the system.

Foreign institutions in China account for about two percent of total loans, whereas in India, it's seven percent.

COMMISSIONER REINSCH: Do either of the other two want to comment?

DR. TSAI: Yes. I actually wrote an article comparing China and India's rural financial systems, and basically India has a much more diverse and sophisticated system of rural financial intermediation and especially when it comes to the provision of microfinance, and it's largely a function of the fact that it's been legal much longer, so there is just a more extensive network of rural banks and credit cooperatives and things like rotating credit associations, which aren't regulated in China, are regulated in India. There's a Chit Funds Act, and so, yes, I'm echoing what Michael was saying, but at the microfinance level in terms of rural finance.

COMMISSIONER REINSCH: Thank you.

MR. CHANG: I think if you want a good comparison to China, Suharto's Indonesia had some aspects which are very similar to China in terms of the political control and the interrelationship between business and the banks. The only thing you didn't see in China is that industrial enterprises don't own banks as they did in Indonesia, but that whole web of relationships is very reminiscent.

COMMISSIONER REINSCH: Thank you.

CHAIRMAN WORTZEL: Commissioner Mulloy.

HEARING COCHAIR MULLOY: Thank you all for your very helpful testimony today and the questions and answers, I'm learning a lot. I'm going to try to get two questions in quickly in my five minutes. State banks, you tell us, are lending mainly to the SOEs, which are a shrinking part of the Chinese economy.

It's my understanding that about 60 percent of China's exports are coming from foreign invested companies rather than Chinese companies. Where do these foreign-invested companies raise their money? Where are they getting their money from? Quickly if you have an idea, and then I want to come back to another issue.

DR. TSAI: Yes. One thing that I didn't mention in my written testimony, which could constitute informal finance, is the reality of round-trip capital which most estimates put at 25 to 30 percent of China's total FDI. So even though China has attracted over US$60 billion in FDI last year, approximately a quarter to a third of that is actually domestic Chinese money leaving China and going back to China.

There are three main forms that this takes. One is establishing an offshore entity in Hong Kong and then routing it through an offshore entity's bank, and then reinvesting it in a domestic firm, which makes it look like a foreign-invested enterprise, and there's a real tax advantage to that because foreign-invested enterprises pay much lower taxes than domestic private enterprises.

The second means for round-trip capital is transfer pricing where they over-invoice exports and under-invoice imports. So it looks like there is a net flow of transfer of funds coming in from abroad.

The third way that this happens is just creating offshore companies to facilitate IPOs which Michael had mentioned.

MR. PETIT: That was a very complete answer. I would only add that reinvested earnings is also a large part of financing. Dividends really don't go out much. Everything is reinvested in the local operations.

HEARING COCHAIR MULLOY: That could imply that the American firms or others that are investing in China are investing a lot more than just the initial investment because they're reinvesting whatever they're making to enhance and expand their operation in China--

MR. PETIT: That's right.

HEARING COCHAIR MULLOY: --to ship more exports back to the United States.

Now that comes to my second question. You mentioned, Mr. Petit, in your testimony on page five: “the greatest risk to credit quality in China is a slowdown or a contraction in global trade. With the U.S. still China's main trading partner and given recent trends in U.S. economic performance and external accounts, these developments could come as a result of a U.S. recession or from protectionist measures.”

So what you're saying is if there's a slowdown in global trade, that's when the Chinese really run into major problems in their financial system. Why is that if the big exporters are not using the state-owned banks in China? How does that happen? I'd be very interested, Mr. Petit, and then if others have comments on that?

MR. PETIT: Very simply put, exports have been one of the main engines for growth of the Chinese economy. So if the economy were to slow down for any kind of reason, marginal borrowers, which don't need to be exporters, would suffer in this more difficult environment which would result in a sharp increase in NPLs.

HEARING COCHAIR MULLOY: I see. Okay.

MR. CHANG: One of the most interesting things over the last year has been the shrinking of the margins of the exporters, and so if you have a global slowdown, you could see many of those exporters just go out of business for no other reason but that.

HEARING COCHAIR MULLOY: I have a minute. The United States, then, does have, if we did take these protectionist measures, as some people would call them--others say trying to get the Chinese to revalue their currency to a realistic value—by increasing our tariffs is not protectionism--we would have significant impact on the Chinese economy if something like that happened here. So we have some leverage here.

DR. TSAI: The U.S. is China's largest source of exports, 21.1 percent, and then Hong Kong is 17 percent, and Japan is 12.4 percent.

HEARING COCHAIR MULLOY: Thank you.

CHAIRMAN WORTZEL: One more question from Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you, Mr. Chairman. Just a very quick follow-up. I just wanted to clarify, with the informal economy now consuming 75 percent, let's say, of all transactions, and the prohibition on PLA participating in the formal economy, has PLA activity in the informal economy supplanted its participation in the formal economy? Is the PLA out in the informal economy doing business, getting loans, and doing the kinds of things that it's not allowed to do in terms of formal policy, or has that really kind of basically been washed away in the informal economy as well?

DR. TSAI: I haven't come across PLA involvement in the informal financial sector in my research.

COMMISSIONER D'AMATO: All right. Thank you.

COMMISSIONER BLUMENTHAL: Yes. I want to of come back to this issue of the political economy and say something blasphemous to economists, which is that the Chinese government are not purely economic maximizers. There's been a recent book by Minxin Pei--Pei Minxin--that talks a lot about how capital and loans are allocated in order to maintain the system, maintain the government, maintain the CCP in power and so forth.

I'm wondering if this conclusion may be accurate, the following conclusion that I'm going to make, which is that loans and other sources of capital are disbursed to groups for reasons that are not purely economic, the groups that the CCP needs to support in order to stay in power. That's the more formal economy.

When you talk about the informal economy, some of the private sector actors who are not perhaps getting access to those loans are more involved in the informal economy, and I want to sort to tie in the question of state corruption, the kind of Suharto type of government that you've mentioned before, just the notion that Mr. Petit said before, the capital is, in fact, not allocated efficiently. I want to get to this notion of the political reasons for why that is. All of you can comment on that.

MR. CHANG: There is still very substantial political control over this entire banking and financial system. Even though the Big Four commercial banks are becoming more commercial and perhaps less state, they nonetheless are subject to very strict and very important state control, and we've seen that, because of misallocation of capital, the numbers have gotten larger over time, not smaller. The NPLs have grown over time and not gotten smaller.

China has the resources and it also has the technical expertise to solve its banking problems, and it's had this not just this year, and not just ten years ago, but it's been there for quite some time, and the fact that this is not getting solved, I think it is the ultimate testament to the political control over the financial system. The financial system, the control may be more subtle than it was in Maoist, in post-Maoist times, but it nonetheless is there because we know that they've got the money to solve these things and they haven't solved them.

COMMISSIONER BLUMENTHAL: Would it be right to conclude that the kinds of groups that would cease to get loans--it would be too much of a threat to the central government to actually solve this problem, which would actually contradict the statement before that they have the will to do so?

MR. CHANG: I think it's partly that they feel an important need to gun the economy, and that's why we see the big increases in fixed asset investment. We have heard a series of stories over the last seven or eight years about how Premier Zhu Rongji and now Premier Wen Jiabao are trying to cut back state stimulus. But nonetheless, fiscal stimulus this year will account for more than half of GDP and more than half of fiscal stimulus will be accounted for from the state.

So there really has been no significant cutback in state control over either the economy as a whole or the banking system. Yes, we've seen some reforms, but the pace of reform, especially over the last two or three years, has slowed down quite considerably, and everybody assumes that China wants to be capitalist and that socialism with Chinese characteristics is really code for capitalism, but it's not.

It's just using the market to help a state-dominated system work better, and it's not clear to me that we're going to see much more in the terms of transition because Minxin Pei talked about a trapped transition, which assumes that they are trying to continue on to a freer state in the economy, but that's not necessarily true. I think that they're just willing to tinker with the system, and that they're really more or less happy with the way it is, which means, for instance, a lot of state control over the important components in the economy, especially the banks.

COMMISSIONER BLUMENTHAL: Anyone else on that?

MR. PETIT: I would add that I don't think any significant central government directed lending anymore. There are still a significant portion of loans that are not extended on a commercial basis, not in regard to risk/reward considerations, but that comes from the local governments typically. They have vested interests. There are pet projects.

Another key consideration is just the labor situation. There is a surplus of underemployed people in China, and that sensitivity is really seen at the local government level. So it's very often more expedient for the local government to extend a loan to a large SOE to keep employment going rather than seeing it collapse when there is no safety net system.

DR. TSAI: I'd like to underscore that. There's very little central state control in terms of state-directed lending. The center is trying to rein in lending; it really is. Growth is a little out of control, and so where there is local state control and intervention in the banking system, yes, that's happening for, as we've already discussed, professional rewards for investment in real estate, but then there are also real fiscal reasons, too.

Two-thirds of China's townships are in a deficit situation. They can't afford to provide very basic public goods like picking up the garbage, paying teacher salaries and things like that, and so in localities where there is a very well developed curb market, the local government is relying on informal finance as fiscal finance.

In areas where they don't have that because the economy just isn't as well developed, they have to keep leaching off the local state banking system just to maintain social stability.

Local cadres are, yes, rewarded for local economic development, but number one, above all, what's considered a high priority target when it comes to the cadre evaluation system is social stability. That's number one and then economic development and everything else.

CHAIRMAN WORTZEL: Thank you for your excellent testimony. It increased our understanding of what's going on. You've been great witnesses. We're going to take a five minute break. We appreciate your being here.

[Whereupon, a short break was taken.]

PANEL II: CHINA'S WTO FINANCIAL SECTOR COMMITMENTS

HEARING COCHAIR MULLOY: On our second panel of today's hearing we're going to be looking at China's WTO financial sector commitments, what they've committed to in the financial services area, and then whether they're complying in letter or whether they're actually complying in spirit, or what are the other issues that our financial firms need to address in terms of access to the Chinese financial services market. We're very fortunate to have with us three very distinguished witnesses.

First, I want to introduce John Dearie. He's the Senior Vice President for Policy and Research of the Financial Services Forum in Washington, D.C. And John, we want to thank you and Secretary Evans for making the effort to have your group be here.

MR. DEARIE: Thank you for inviting us.

HEARING COCHAIR MULLOY: If you could extend to him my personal thanks for that.

MR. DEARIE: I certainly will.

HEARING COCHAIR MULLOY: We have with us also Ms. Vickie Tillman, who's the Executive Vice President for Credit Market Services of Standard and Poor's in New York City.

And then I saved one of my favorites till last, Steve Judge, who is the Senior Vice President for Government Affairs of the Securities Industry Association. Steve is an old friend who worked many years on the Hill on these important issues. He knows many of the commissioners, but we thank you and the Securities Industry Association for all your help to this Commission. You testified at one of our first hearings, and we're very pleased that you're back here again.

Why don't we go across from Mr. Judge to Ms. Tillman and Mr. Dearie. You each will have seven minutes. Watch the clock, and then we'll open up a round of questions from the commissioners. Thank you again for being here.

STATEMENT OF STEVE JUDGE, SENIOR VICE PRESIDENT SECURITY INDUSTRIES ASSOCIATION, NEW YORK, NY

MR. JUDGE: Chairman Wortzel, Chairman Mulloy, thank you for those kind remarks. I appreciate them very much. Members of the Commission, I'm Steve Judge, Senior Vice President, Government Affairs, Securities Industry Association.

I appreciate the opportunity to testify today about China's capital markets and appreciate this Commission's continued interest and efforts. The securities industry views China as the world's largest single emerging market opportunity. I also wish to take this opportunity to commend members of the House and Senate and the U.S. Department of Treasury for the continuing work and active engagement in seeking open and fair markets for securities firms in China.

In particular, the Treasury Department through the establishment of the U.S.-China Financial Markets Dialogue and the placement of a Treasury Financial Attaché in Beijing has put in place a framework for a lasting and active advocacy on behalf of the U.S. financial services sector.

My testimony will focus on the goals and objectives of the U.S. securities industry and our growing relationship in China's economy. China's WTO accession for the securities industry demonstrated a reluctance to open up this sector fully to foreign competition. As a result, since China's accession to the WTO, nearly $24 billion has been committed to China's financial services sector, and according to our estimates, less than 600 million of that total has found its way into the securities firms.

China's 2001 WTO accession commitments in the securities sector marked this country's first step towards liberalizing its capital markets. The commitments permit foreign firms to participate in the securities sector only through joint ventures in which foreign ownership is capped at 33 percent.

It also places limits on the types of transactions and businesses in which the joint ventures can engage. These commitments make no provision for further increases in foreign ownership in these security firms. Instead, the commitment suggests that without a change in policy, foreign investors will remain minority shareholders in local securities firms for the foreseeable future.

In the context of the ongoing WTO financial services discussions, in other trade fora, or in government-to-government discussions, SIA is focusing on the following priorities: permission for full ownership; liberalization of standards for qualified foreign institutional investors; implementation of a qualified domestic institutional investors' program; promotion of regulatory transparency; and liberalization of derivatives regulation.

China should allow foreign firms to establish securities companies, including wholly-owned entities with the ability to engage in a full range of securities activities. Currently, foreign investors can enter China's securities markets in two ways: by establishing a new joint venture with a Chinese partner or by taking a stake in an existing brokerage. Because in most cases the negotiations that result in a joint venture or a foreign stake are opaque, potential entrants have little available in the way of guidance on how to arrange such joint ventures.

We are also very concerned about what appears to be an unofficial moratorium on foreign security firm joint ventures in China. China's decision to permit foreign investment in A shares through qualified foreign institutional investors, or QFIIs, was a landmark step in development and liberalization of China's capital markets.

More recently, the Chinese government has taken steps to increase the number of QFIIs and the amount invested. Nevertheless, some of the requirements placed on these are onerous and have substantially limited the utility of this program.

China would make its securities markets more attractive to investment through the liberalization of QFII restrictions. Such progressive liberalization done in consultation with foreign and domestic capital market participants would almost certainly result in greater foreign investment in China's securities markets, deepen and broaden trading in those markets, increase capital availability to Chinese issuers.

China is in the process of launching its long-awaited qualified domestic institutional investor program. This is to promote Chinese investment in foreign stocks and bonds. The People's Bank of China announced the launch of the program in April 2006. They released interim measures that permit qualified commercial banks to pool renminbi from domestic institutions and individuals and convert them into foreign exchange for investment overseas in fixed income securities.

Other implementation rules will eventually expand this program to qualified mainland insurance companies, fund management firms, and securities firms.

Transparent and fair regulatory systems play an integral role in the development of deep liquid capital markets that attract market participants, increase efficiency and spur economic growth and job creation.

Though the Chinese Securities Regulatory Commission has improved its policies on prior consultation and has presented many proposed regulations for public comment, much progress is still needed.

Short comment periods are insufficient to review complex new regulations, particularly those that are intended to affect foreign firms whose ability to comment is hampered by distance and language.

A transparent industry is generally one in which the public and the industry participants have the opportunity to be involved in the rulemaking process, access information about proposed rules, question and understand the rationale behind those draft rules, and have sufficient opportunity to review and comment.

Lastly, China should liberalize its derivatives regulations that take advantage of the new and essential risk management tools that are available in the marketplace.

Interim derivative rules which took effect in March 2004 have prohibited securities firms from creating and distributing derivative products. The inability of securities firms to engage in these activities hampers the development of the derivatives markets in China. Foreign firms hope that China will revise its securities laws to formulate measures on the issuance and trading of derivatives.

In conclusion, while considerable progress has been made in liberalizing China's capital markets, much work remains. Continued liberalization of China's markets has clear benefits for China and for the global economy. It is critical that the U.S. government including all its relevant agencies is engaged in the coordinated effort to help U.S. securities firms gain full access to these markets.

We look forward to working with the Commission, Congress, the administration, to further expand our operations in China. Thank you.
[The statement follows:]

Prepared Statement of Steve Judge, Senior Vice President Government Affairs, Securities Industry Association New York, N.Y.[4]

HEARING COCHAIR MULLOY: Thank you. Ms. Tillman.

STATEMENT OF VICKIE A. TILLMAN EXECUTIVE VICE PRESIDENT, STANDARD & POOR'S CREDIT MARKET SERVICES, NEW YORK, NY

MS. TILLMAN: Mr. Chairman and members of the Commission, good morning. I'm Vickie Tillman, Executive Vice President of Standard and Poor's Credit Market Services, which includes the Rating Services. This is the unit responsible for assigning and publishing credit ratings of issuers and securities.

I welcome the opportunity to appear before this Commission to discuss China's financial regulatory system, particularly as it applies to capital markets, foreign credit rating agencies, and per the Commission's request, in this testimony I will address some related topics:

First, a comparison of China's regulatory environment with those of other Asian countries; Chinese regulators' perception of the role of

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[4] Click here to read the prepared statement of Steve Judge

credit ratings and credit rating agencies in today's global financial markets; regulatory and other barriers that limit foreign rating agencies from entering and competing in China's capital market; and while I was going to go over the banking industry, I thought we had a fairly extensive review this morning, so I'll probably limit my comments as it relates to that.

We've had ongoing dialogue with the USTR, the International Trade Commission, the American Embassy in Beijing, as well as the Chinese government officials, on these issues, and I look forward in sharing our thoughts on them with you today.

Our overall view is that while significant structural reform in China's capital market environment continues to take place, further progress is needed, especially with respect to allowing foreign credit rating agencies to compete on par with local agencies and to operate independently.

Before turning to these topics, I would first like to provide some background on our participation in the Chinese market. We've been in the Asia Pacific region since the '70s. We opened up our first Asian office in Tokyo in 1985. We now have nearly 1,500 staff in Japan, India, China, Hong Kong, Singapore, Korea, Taiwan, Malaysia and Australia.

Standard and Poor's is committed to supporting the development of efficient, transparent, and dynamic capital markets, and it dates back to 1991 when we rated China's first U.S. denominated sovereign debt, and as Mr. Petit has said, that has actually increased, most recently a month ago, to a single A rating.

We have rated 45 ratings in China of corporate banks and corporations, those that were listed in Hong Kong, and they tend to be cross-border debt. And to accommodate the local market needs, S&P has sponsored and participated in many conferences and meetings with market players including regulators on an ongoing basis.

The primary reason for that is not just to gain an understanding of what their thinking is about the capital markets and ratings and credit, but also to transfer information and knowledge about how more efficient more transparent markets operate and why this would be a positive thing for the Chinese government to take into consideration.

As a further commitment to the Chinese market, we opened up an office in Beijing in 2005. It is a wholly-owned foreign enterprise. We hope that at some point in time that we will be given regulatory authority to provide ratings, but at this point in time we currently are not.

Unfortunately, the likelihood of receiving this authorization is increasingly remote for the reasons I will discuss in a moment.

Comparing Chinese regulatory stance on capital markets and ratings agencies of other nation's in the region, we have generally found a greater openness and recognition for the need for rating agency independence and for rating agencies to conduct domestic ratings in key Asian financial centers like Japan, Hong Kong, Singapore, Australia rather than in China.

The governments in these markets have embraced the importance of accepting global standards in the financial service industries for both equity and debt capital markets, seeing this as the best way for building competitive and borderless capital markets for global investors.

In Japan and Hong Kong, the respective regulatory agencies have adopted a recognition approach of foreign credit rating agencies. In other words, they recognize CRAs as External Credit Assessment Institutions for the purpose of Basel II.

This approach is in line with many other economies like the United Kingdom, Canada, other parts of Europe. Even in smaller economies like Malaysia, regulators have adopted a recognition approach by requiring Credit Rating Agencies to obtain Securities Commission recognition for purpose of conducting ratings for certain issuances/investments and by requiring the CRAs to adopt the IOSCO Code of Conduct Fundamental Credit Rating Agencies.

But outside the ECAI recognition scheme under Basel II, CRAs operate without regulatory license or other formal approvals in other parts of Asia.

We're generally impressed by the evidence that Chinese regulators continue to review and enhance regulation by adopting best practices and international standards such as securities legislation, risk management and corporate governance, and there's an increasing emphasis on disclosure and accountability for timely, complete, and accurate dissemination of information.

In addition, there appears to be an increasing cooperation amongst Chinese regulators with international organizations to promote high standards to exchange information and provide mutual assistance.

The problem for rating agencies in China is less about regulators' level of understanding of credit ratings than lack of any clear regulatory authority over the industry, a topic I detailed in my written submission to the Commission.

Not surprisingly, the growth of Chinese corporate bond issuance has increased, although at a relatively small size, as well as the demand for structured finance deals is focusing the Chinese regulators' attention on the need for greater clarity among their various jurisdictions and better rules for governing debt issuance.

There have been reports some of these issues will be taken up in

China's 2007 National Financial Work Conference that takes place. Reforming the credit environment appears therefore to have become a priority.

Despite progress, we are not optimistic that the picture for foreign rating agencies will change any time soon in China where there remains an ambivalent attitude toward foreign-owned entities.

One reason for this pessimism is the draft bill circulated by the Chinese Securities Regulatory Commission late last year governing the market for credit ratings in China, entitled "Measures for the Administration of Securities Credit Rating Service." If enacted, the current proposal would significantly restrict the ability of international rating agencies to participate in China's domestic credit ratings market. They impose a regulatory regime that severely limits the ability to conduct independent, high quality credit analysis, and require the international credit rating agencies to partner with a local Chinese firm.

HEARING COCHAIR MULLOY: Ms. Tillman, we're going to have to ask you to just give us your final summary, and then we'll get into the questions.

MS. TILLMAN: Okay. Great. But in conclusion, the good news is that the Chinese regulators are seeing the importance of it. The bad news, because it so diverse, who controls the aspects of the securities markets and the rating agencies, unless there's a unified voice in the regulatory environment, we don't see in the near future that we will be able to operate with the freedom that is required in terms of unbiased credit assessment, which is needed in China.

Thank you very much.

[The statement follows:]

Prepared Statement of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Market Services, New York, NY[5]

HEARING COCHAIR MULLOY: Thank you. Mr. Dearie.

STATEMENT OF JOHN R. DEARIE SENIOR VICE PRESIDENT FOR POLICY RESEARCH, THE FINANCIAL SERVICES FORUM, WASHINGTON, D.C.

MR. DEARIE: Thank you. Cochairmen Wortzel and Mulloy and members of the Commission, thank you for the opportunity to participate in this important hearing on China's accession into the World Trade Organization and the implications for American financial services

[5] Click here to read the prepared statement of Vickie A. Tillman

firms in the broader U.S. economy.

I'd like to begin, first of all, by thanking all of you for your service as members of this Commission. The work that you do in reporting to and advising the Congress on the economic relationship between the United States and China and its implications for our national security is of vital and growing importance.

As you know, I'm here as Senior Vice President of the Financial Services Forum, a financial and economic policy organization, comprised of the chief executives of 20 of the largest financial institutions with operations in the United States.

Charles Prince, the CEO of Citigroup, is the Forum's current chairman, and as you mentioned, former Commerce Secretary Don Evans is the Forum's chief executive.

As this Commission is aware, under the terms of its December 2001 WTO accession, China committed to implement a set of sweeping reforms that required the lowering of barriers to trade in virtually every sector of its economy as well as national treatment and improved market access.

With regard to the financial sector, China's commitments fall principally into the category of progressively increased market access for foreign banks, insurers and other financial services firms, the details of which I provided in my written testimony.

The phase-in period for many of these commitments has already been completed, while in other areas, and particularly banking, such obligations must be met, as you know, by December 11 of this year which will mark the five-year point since China's accession.

As to whether China is fulfilling its financial sector obligations, the answer is basically yes in the view of the Forum, although there have been a number of procedural and regulatory issues that have frustrated foreign financial institutions as they have sought to take full advantage of China's market access obligations, as my two other panelists have alluded to.

In 2002, for example, the People's Bank of China issued capital requirements and other prudential rules for foreign banks that far exceeded international norms, was slow to act on foreign banks' applications, and allowed foreign banks to open only one branch every 12 months.

Similar problems have been experienced by foreign insurance companies such as the approval of new branches on a strictly sequential basis rather than on a concurrent basis, and the securities sector has experienced similar problems, as Steve talked about.

The Treasury and Commerce departments along with the U.S. Trade Rep's Office are actively working with their Chinese counterparts to extend foreign access to Chinese financial markets and to pursue financial regulation that is more predictable, transparent, and in keeping with international norms, and certainly the Forum applauds those efforts.

It should be pointed out that China has achieved some progress beyond what was negotiated as part of its WTO commitments and has taken important steps to liberalize its financial sector and to improve its financial regulation. The Financial Services Forum applauds such progress and urges that much more be achieved.

Indeed, despite the achievements to date, China's financial sector still faces serious challenges, many of which were talked about on the last panel, including: non-commercial lending to state-owned enterprises continues, although on a diminishing scale; the stock of non-performing loans on banks' balance sheets remains alarmingly high; banks are undercapitalized and lending practices, internal controls and risk management techniques remain inadequate; prudential supervision and regulation of the financial sector still lags behind international best practices; and at present, as you know, investment by foreign financial institutions in Chinese banks is limited to 20 percent ownership stakes with total foreign investment capped at 25 percent.

Notwithstanding the clear benefits that foreign know-how and expertise would bring to China's financial system, foreign institutions currently control less than two percent of the assets of the Chinese banking system.

With these problems in mind, efforts to build on the progress achieved to date should focus on the critical importance of an open commercial banking system, capital markets and insurance products to promoting the consumption-led growth that China's leaders seek; the clear benefits to China of increased market access for foreign financial services firms--namely, as I mentioned, the importation of world-class know-how, technology and best practices; the importance of financial and regulatory transparency; and the implementation of global standards regarding corporate governance.

In this regard, I'd like to mention that Secretary Evans, the Forum's CEO, traveled to China just two months ago. The purpose of his trip was to engage China's political and business and financial leaders on these issues of China's economic development, financial sector reform and market access for American companies.

I'm pleased to report that Secretary Evans came away from these meetings convinced that China's financial leaders understand that greater reliance on market principles, a more flexible exchange rate, and increased foreign investment are utterly in China's interests, and that they remain committed to further modernization of the financial sector.

Continued progress toward the modernization of China's financial sector is in the interest of the United States because a stronger, more sophisticated, more resilient financial sector is a prerequisite for China's continued economic development and its ability to extend westward the prosperity experienced principally in the east.

As China's transition period as a new member of the WTO comes to an end, U.S. trade policy should move beyond the monitoring of China's compliance with a discrete set of obligations to more proactively cooperating in an increasingly dynamic relationship, the aim of which should be to ensure that China participates fully and constructively as a mature and responsible stakeholder in a multilateral global trading system.

For the United States, this means a bilateral relationship with China that is more balanced, is more equitable and more durable. As U.S. policymakers and trade negotiations adjust our priorities and methods to meet this new challenge, the advice and input of this Commission will be more important than ever.

Thank you very much for the opportunity to be here.

[The statement follows:]

Prepared Statement of John R. Dearie
Senior Vice President for Policy Research, The Financial Services Forum, Washington, D.C.

Co-chairmen Wortzel and Mulloy, members of the Commission, thank you for the opportunity to participate in this important hearing on China's accession into the WTO and the implications for American financial services firms and the broader U.S. economy. I'd like to begin by thanking all of you for your service as members of this Commission. The work you do reporting to and advising the Congress on the economic relationship between the United States and China, and its implications for our national security, is of vital and growing importance.

I am here as Senior Vice President of the Financial Services Forum, a financial and economic policy organization comprised of the chief executives of 20 of the largest financial institutions with operations in the United States. Charles Prince, CEO of Citigroup, is the Forum's current Chairman, and Former Commerce Secretary Don Evans is the Forum's chief executive.

The 20 member CEOs of the Financial Services Forum meet twice a year, our most recent meeting occurring this past April. At that meeting, for the first time, we conducted a survey of our members regarding their outlook on the U.S. and global economies. The answers we collected are of special value because, as the CEOs of 20 of the world's largest financial institutions, our members enjoy a unique vantage point on the U.S. and global economies.

As part of the survey, we asked our CEOs to rate a number of factors, including technological innovation, improved education, freer and more open trade, and growth in a number of regions around the world, to reflect their likely contribution to global economic growth over the next decade. The CEOs were asked to assign a number between 1 and 5 to each rated factor, with "1" being "not important" and "5" being "the most important." Our CEOs rated growth in China as the single most important source of growth of the global economy, with an average rating of 4.5.

Mr. Chairman, the rate of China's expansion and the impact of its integration into the global trading system are unprecedented in the history of the world's economy. Since 1980, more than 400 million Chinese have been lifted out of poverty, and over the last four years the United States and China have accounted for half of global economic growth. How this critical relationship is managed is sure to be one of the most important factors determining the growth and stability of global economy in the 21st century.

China's WTO Obligations in Financial Services

As this Committee is aware, under the terms of its December 2001 WTO accession, China committed to implement a set of sweeping reforms that required the lowering of barriers to trade in virtually every sector of its economy, as well as national treatment and improved market access. With regard to the financial sector, China's commitments fall principally into the category of progressively increased market access for foreign banks, insurers, and other financial services firms. The phase-in period for many of these commitments has already been completed, while in other areas, particularly banking, such obligations must be met by December 11th of this year, which will mark the five-year point since China's accession.

<u>Banking</u>:

Prior to China's WTO accession, foreign banks were not permitted to engage in local currency business with Chinese clients, and the establishment of foreign banks was severely restricted geographically. As part of the WTO agreement, China agreed to:

- allow foreign banks, immediately upon accession, to conduct foreign currency business without restriction and, in certain cities, local currency business with foreign individuals and foreign-invested enterprises,

- allow foreign banks to conduct local currency business with Chinese enterprises beginning two years after accession, and with Chinese individuals after five years, and,

- grant foreign banks national treatment, and remove any remaining geographic or client restrictions, by December 11, 2006.

<u>Insurance</u>:

Prior to accession, China allowed selected foreign insurers to operate in China on a limited basis in only two cities. As part of its WTO commitments, China agreed to:

- allow foreign life insurers to hold up to 50 percent ownership in a joint venture upon accession;

- allow foreign property, casualty, and other non-life insurers to establish as a branch or joint-venture with up to 51 percent equity share upon accession, and to establish wholly foreign-owned subsidiaries with two years of accession;

- phase out over three years all existing geographic restrictions on all types of insurance activities;

- allow foreign insurers engaged in large-scale commercial risk, marine, aviation, or transport risk activities, as well as reinsurance, to participate in joint ventures with foreign equity share of 50 percent upon accession, 51 percent after three years, and to establish wholly foreign-owned subsidiaries after five years.

<u>Securities and Other Financial Services</u>:

- Foreign firms may establish securities operations in China by way of joint-ventures in which foreign ownership is limited to 33 percent. Such joint-ventures are permitted to underwrite domestic company shares (A), foreign currency shares (B) and Hong Kong registered shares (H), as well as corporate and government debt, and to trade in all these securities, except A shares.

- Foreign firms may also establish asset management operations by way of joint-ventures in which foreign ownership is limited to 49 percent.

As to whether China is fulfilling its financial sectors WTO obligations, the answer is basically yes, although there have been a number of procedural and regulatory issues that have frustrated foreign financial institutions as they have sought to take full advantage of China's market access commitments.

In 2002, for example, the People's Bank of China (PBOC) issued working capital requirements and other prudential rules for foreign banks that far exceeded international norms, was slow to act on foreign banks' applications, and allowed foreign banks to open only one branch every 12 months. Similar problems have been experienced by foreign insurance companies, such as the approval of new branches on a strictly sequential basis rather than a concurrent basis. In addition, in December of 2005 the China Securities Regulatory Commission (CSRC) imposed a moratorium on foreign investments in Chinese securities firms. While the moratorium may not be a technical violation of China's WTO commitments, it is clearly a step in the wrong direction.

Since its creation in April of 2003, the China Banking Regulatory Commission (CBRC) has eliminated many of the PBOC's more onerous requirements on foreign banks. However, just last week, the CBRC circulated a draft announcement that would require foreign banks to incorporate their local operations in China in order to engage in yuan-denominated business with Chinese individuals by the end of the year, as required under China's WTO commitments. Local incorporation would be expensive for foreign banks, who currently run their Chinese branches from overseas headquarters. Local incorporation would require separate capitalization and would likely entail significant legal and tax implications.

It's important to acknowledge such problems and to work toward their swift resolution. And, indeed, the Treasury and Commerce departments, along with the U.S. Trade Representative's office, are actively working with their Chinese counterparts through the Financial Sector Working Group, the Joint Commission on Commerce and Trade, and the China Enforcement Task Force to extend foreign access to China's financial markets and to pursue financial regulation that is more transparent, predictable, and in keeping with international norms. The Forum commends these important efforts.

At the same time, such difficulties must be considered with the understanding of just what the Chinese undertook in joining the WTO and what they have achieved in a very short period of time. Following 15 years of negotiations, China agreed to extensive, far-reaching, often very complex commitments, at all levels of government. Fulfilling these commitments has required nothing short of a wholesale institutional transformation of China's financial system and the relationship between government and major industries – a transformation that is painful, stressful, expensive, and that has no comparison in

American history.

It should also be pointed out that China has achieved progress beyond what was negotiated as part of its WTO commitments. For example, China opened several cities ahead of schedule for foreign banks' domestic currency business. It has also taken important steps to liberalize the financial sector and to improve financial regulation. For example:

- The financial sector has been transformed from a single-bank system to a more diversified system with a central bank at the helm;

- Meaningful steps have been taken to get state banks out of the business of state-directed policy lending, and amendments to the Law on Commercial Banks and the Law on the Peoples Bank of China have laid the foundations for commercially viable lending;

- The CBRC was established in April of 2003 to oversee all banks and financial institutions in China, investigate illegal banking operations, and punish violations of law; and,

- Interbank, equity, and foreign exchange markets have been established and important progress made in the use of indirect means of monetary policy.

The Financial Services Forum applauds this progress to open and modernize the Chinese financial system – and urges continued progress. Indeed, despite the achievements to date, China's financial sector still faces serious challenges:

- Non-commercial lending to state-owned enterprises continues, although on a diminishing scale;

- The stock of nonperforming loans on banks' balance sheets remains alarmingly high;

- Banks are undercapitalized and lending practices, risk management techniques, and internal controls remain inadequate;

- Prudential supervision and regulation of the financial sector still lags behind international best practices; and,

- At present, investment by foreign financial institutions in Chinese banks is limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. Despite the clear benefits that foreign know-how and expertise would bring to China, foreign financial institutions currently control less than 2 percent of the assets of the Chinese banking system.

With these problems in mind, efforts to build on the significant progress achieved to date should focus on:

- the critical importance of an open commercial banking system, capital markets, and insurance products to promoting the consumption-led economic growth that China's leaders seek;
- the clear benefits to China of increased market access for U.S. financial services firms – namely the importation of world-class know-how, technology, and best practices.

- the importance of financial and regulatory transparency; and,

- the implementation of global standards regarding corporate governance.

Opportunities in China that Would Benefit the U.S. Economy

Without question, continued reform of China's financial sector is in the interest of American financial services providers and the U.S. economy more broadly. American financial institutions – along with American manufactures, farmers, and other service providers – naturally perceive China's fast-growing middle class and new businesses as potential consumers of U.S. products and services. Opportunities of particular interest to U.S. financial services firms would include China's expanding credit card market, auto financing, mortgage lending, corporate lending, and investment banking.

More fundamentally, continue progress toward the modernization of China's financial sector is in the interest of the United States because a stronger, more sophisticated, and more resilient financial system is a prerequisite to China's continued development – and its ability to extend westward the prosperity experienced principally in the East.

Starting a business, expanding an existing business, buying a home, sending a child to college – any productive or entrepreneurial activity – requires investment capital. Money and credit are the lifeblood of any economy. As the financial sector becomes more developed and sophisticated, capital formation becomes more effective and efficient, increasing the availability of investment capital and lowering costs.

A more developed and sophisticated financial sector also increases the means and expertise for mitigating risk – everything from derivatives for businesses to avoid price and interest rate risks, to insurance products to mitigate the risk of accidents and natural disasters. The depth and flexibility of the financial sector is also critical to the broader economy's resilience – its ability to weather, absorb, and move beyond the inevitable booms and busts of a dynamic economy. For these reasons, an effective and efficient financial sector is the essential basis upon which the growth and vitality of all other sectors depend. It is a "force multiplier" for progress and development, amplifying and extending the underlying strengths of a growing economy. Research conducted by McKinsey indicates that a more open and modern financial system would expand China's economic output by as much as 17 percent, or $320 billion a year.

A modern, more sophisticated financial system would also facilitate important aspects of U.S. trade and economic policy with China. For example, one reason why Chinese authorities have resisted further flexibility in the exchange rate is that China's banks, securities firms, and businesses enterprises lack the expertise to develop and trade derivatives and other structured instruments used to hedge the risk associated with great currency volatility. A more efficient financial system would also help to mobilize Chinese consumer consumption, a critical aspect of China's effort to restructure its economic growth and to address international trade imbalances.

Secretary Evans' Recent Trip to China

In this regard, I'd like to mention that Secretary Evans, the Forum's CEO, traveled to China just two months ago. The purpose of his trip was to engage China's political, business, and financial leaders on issues of China's economic development, financial sector reform, and market access for American companies.

As you might recall, Secretary Evans, along with then U.S. Trade Representative Robert Zoellick, co-chaired the highly successful meeting of the Joint Commission on Commerce and Trade (JCCT) in April of 2004 during which no fewer than seven potential disputes over China's WTO compliance were successfully resolved.

While in China, Secretary Evans met with a number of China's financial authorities including Liu Mingkang, the Chairman of the China Banking Regulatory Commission; Shang Fulin, Chairman Of China Securities Regulatory Commission; Li Yong, Vice Minister of Finance; Li Kemu, Vice Chairman of The China Insurance Regulatory Commission; Madam Hu Xiaolian, Vice Governor of The People's Bank of China; and Liao Xio Qi, Vice Minister of Commerce.

I am pleased to report that Secretary Evans came away from these meetings convinced that China's financial leaders are committed to further modernization of China's financial sector. China's financial authorities understand that it's in the best interest of the country's long-term growth, job creation, and general well-being of its citizens to move toward ever-greater reliance on market principles, a more flexible exchange rate, and increased foreign investment in Chinese financial institutions. This message is consistent with the announcement by the CBRC last September that current caps on foreign investment in Chinese banks were under review and will be gradually lifted, beginning later this year.

Conclusion

Mr. Chairman, China's membership in the WTO beginning in December of 2001 was the culmination of more than 25 years of political and economic engagement by the United States. Such cooperation has broadened and deepened the relationship between our two countries, to the benefit of both. Since 2001, trade between the United States and China has more than doubled from $121 billion to $285 billion, exports to China have grown at five time the pace of U.S. exports to the rest of the world, and China has risen from our 9th largest export market to our 4th largest.

But our work to help China integrate into the global economy is not finished. Indeed, in a very real sense, the easy part is over. As China's transition period as a new member of the WTO comes to an end, U.S. trade policy should move beyond the monitoring of China's compliance with a discrete set of obligations to more proactively cooperating in an increasingly dynamic relationship, the aim of which should be to ensure that China participates fully and constructively as a mature and responsible stakeholder in a multilateral, global trading system. For the United Stated, this means a bilateral relationship that is more balanced, equitable, and durable.

As U.S. policymakers and trade negotiators adjust our priorities and methods to meet this new challenge, the advice and input of this Commission will be more important than ever.

Thank you very much for the opportunity to participate in today's hearing.

Panel II: Discussion, Questions and Answers

HEARING COCHAIR MULLOY: Thank you very much, all three of you, for your prepared testimony. Your prepared testimony will be put into the record of the hearing in full and will appear on our Website.

Chairman Wortzel.

CHAIRMAN WORTZEL: Ms. Tillman, I wanted to pursue one of the issues you raised about foreign ratings firms being able to operate. Is there any recourse other than political pressure by a series of governments that would help foreign firms enter the market in China in ways that are not restricted to joint ventures?

Are there any measures that in a regulatory sense or a legislative sense Congress or the executive branch can take? And is your concern that if these ratings are part of a joint venture activity, that foreign rating firms will be subject to Chinese government pressure to manipulate the ratings?

MS. TILLMAN: I think on the first part of your question, sir, is that as the Chinese government and the regulators as well as those participating in the market understand that the technology that is brought in by having best practices, international standards around understanding the risk of credit, which to be quite honest is a pretty nascent activity at this point in time in China, that that will only really open and create a more transparent economy and financial system that investors and others can begin to trust better.

So from that perspective, as we talk about how other markets have worked and opened and become more transparent, even those in Asia, their counterparts in Asia, that that would significantly help so that kind of continued dialogue is very important.

Right now in terms of the joint venture, a current recommendation is that it's around 49 percent--that you could have in one of the five recognized local rating agencies in China. And from our perspective, 49 percent ownership interest, however, does not necessarily give the foreign rating agency the opportunity, for that matter probably the want, to operate in the domestic market as its currently set up.

As I said earlier, the corporate domestic bond market is very small, and right now most of the local rating agencies, as they operate, are operating on an inter-bank market and/or commercial paper market. It's truly not to what we would consider a true capital market environment.

But the positive aspects of working with a local agency is that you can transfer best practices, you can transfer education around what corporate credit is and how it should be looked at, so it can help advance the knowledge within China and the local rating agencies. However, the current proposed regulatory environment for operating as a foreign rating agency really has some very restrictive elements in it such that the rating committee wouldn't necessarily have to register with the CSRC, and those that are voting in a rating committee. And from our perspective, that certainly doesn't give us a sense of confidence that the ratings that would emerge would be unbiased and independent.

So with regulatory restrictions such as those, we don't find that the current legal representation by this regulation is anything that we could currently work with, albeit, we have responded to it. We are talking to them in terms of why those restrictive elements do not work in terms of transparency, as well as in terms of getting accurate credit information out in the marketplace. They are listening, but as I said earlier, the pace has been very slow in terms of acting.

CHAIRMAN WORTZEL: When you talk to people in China, do you talk to the NPC or legislative bodies in China? Is there a lobbying process, so to speak?

MS. TILLMAN: We talk to all four regulatory bodies. As I indicated, they all tend to regulate different aspects of the securities and bonds markets. So, in relation to the banks, we talk to the banking commission. When it's in the insurance area, we talk insurance area. The NRDC has a regulatory oversight over rating agencies as well. So really when we talk to them and dialogue with them, it's actually every single one of them, in addition to other government officials, and those that may have interest in why it is important to have global credit standards in a financial services market.

CHAIRMAN WORTZEL: Thank you.

HEARING COCHAIR MULLOY: Commissioner Wessel.

COMMISSIONER WESSEL: Thank you to the panelists and, Steve, good to see you up here again. I'd like to follow up on Commissioner Wortzel's discussion about what can be done, and I'm reminded of the CNOOC transaction last year, where--Ms. Tillman, you have used the term "confidence" quite a number of times--there was lack of confidence here in our market and certainly on Capitol Hill about the true commercial nature of the transaction.

Do we have leverage to enhance the position of our credit rating agencies vis-à-vis Chinese firms? You indicated, I think, only 45 have been rated by your firm. That should they seek to, through their go-out strategy, engage in transactions in our market, either through a CFIUS review of a purchase of a U.S. entity, or seeking to float debt or equity instruments on any of our markets, that we could require that internationally recognized credit-rating agencies actually engage in those transactions to review them?

MS. TILLMAN: We currently generally do engage in any cross-border type of ratings.

COMMISSIONER WESSEL: So in the CNOOC situation, for example, where our credit rating agency is going in and looking at the nature of the financing for that transaction, were you able to look at the books and be able to give confidence here as to the nature of the transaction?

MS. TILLMAN: To be quite honest, I was not involved in that particular transaction so I couldn't really speak to it. But I think what we're really talking about here is having a level playing field. I think a number of other panelists have talked about it, whether it be in the securities industry, whether it's in the banking industry or the insurance industries, having the ability to operate at the same level, if not at a higher level, than the local rating agencies.

The local rating agencies there, as I said, do not have the technical expertise to really opine to the creditworthiness of some of the types of corporate bond issues. And for that matter in terms of securitization really had no know-how in terms of securitization markets, which a lot believe would help in terms of relieving some of the non-performing loan problems in China as well.

COMMISSIONER WESSEL: I certainly agree that we should be seeking to open their market more for our financial institutions. But until we're able to achieve that, do we have any leverage as they seek--

MS. TILLMAN: The leverage is them knowing that they need to have a more robust corporate bond market to help for the internal investment in China, and currently to have a more robust local bond market, they're going to need rating agencies that apply global standards with a local understanding to those credit assessments. That currently does not exist and until that happens, I think--

COMMISSIONER WESSEL: I understand and agree. My question is until we get to that point, because of our desire to protect investors here and access to our market, do we have the leverage to enhance your organization and others who do the credit rating the ability to get into their books if China wants to pursue its go-out strategy accessing international markets, that our investors have a right to have a more transparent system?

MS. TILLMAN: I think as part of our general rules of engagement at Standard and Poor's and other international rating agencies, that if you don't feel that you have the sufficient transparency, then you can choose not to rate the bonds. That's the leverage that you have. So for them to truly access the capital markets outside of the United States, they will have to become more transparent, they will have to have more audited information that people can put some faith into.

We can't require them to get it, but what we can do and what others can do is choose not to invest in them or to rate them. I think that's where the leverage would come from.

COMMISSIONER WESSEL: So we don't have the ability to require, let's say for a CFIUS transaction, that there be a credit rating agency involved in looking at the financing of the deal?

MS. TILLMAN: Currently that doesn't exist.

COMMISSIONER WESSEL: But we could potentially change the law to look at that opportunity?

MS. TILLMAN: You could, yes.

COMMISSIONER WESSEL: Thank you.

HEARING COCHAIR MULLOY: Thank you, Commissioner

Wessel. Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you all very much for your testimony. We heard testimony in an earlier panel about there was some dispute about the possibilities of some sort of banking crisis or credit crunch or something of that nature, but we certainly had testimony that it's in the realm of possibility and would then lead to a contraction of economic growth, and certainly in the state sector create problems and so forth.

In your testimony, it seems that most of the organizations that are members are eager to invest more heavily in China and to enter the market still like gangbusters. I wonder if your organization or your members take any of these risks into account in the sense of the kind of testimony we heard beforehand, that the non-performing loan problem, the dispute of whether China has the will to actually solve this problem, the possibilities for some sort of unforeseen serious crisis? It seems like your member companies are going in the other direction.

MR. DEARIE: I listened to the prior panel, and it seemed that there was some disagreement as to the state of the Chinese banking system, and there is no disagreement about the seriousness of the non-performing loan problem. It is very, very serious. As for whether that portends some kind of a crisis in the banking system, there did seem to be some disagreement.

I would certainly count myself, and by the actions that you allude to of the member institutions of the Financial Services Forum and other organizations, I think that they would tend to count themselves among the more sanguine corners of those who are looking at the situation in China.

I think that clearly these institutions like Citigroup, like HSBC, like Deutsche Bank, like Goldman Sachs, all of these very, very large financial services firms who are going into China, are making the very clear bet, based on very, very careful world-class due diligence, as was alluded to in the last panel. These are not exactly fly-by-night institutions.

COMMISSIONER BLUMENTHAL: Are they more sanguine because they have information that we perhaps don't have access to or why are they more sanguine than say some of the other economists that say that there really is substantial risk in entering?

MR. DEARIE: I certainly think that there is some risk. There is a risk entailed in any investment. I think what these institutions are betting is that the clear problems notwithstanding that (a) the upside benefit of being involved and invested in China will far outweigh the costs associated with any risks that they're aware of at the moment.

I think what is also contributing to their upbeat or bullish impression of China is that the Chinese authorities really do get and they acknowledge that they have problems. It would be a far less sanguine situation if the situation at the official levels was characterized more as avoiding problems or trying to minimize them. I think the Chinese authorities understand that they have problems.

I think they're working very hard to come to terms with those problems. The kinds of frustrations and impediments that some of the Western financial firms have encountered, even in the context of the Chinese meeting their WTO obligations, I think that the Chinese have worked very, very hard and have come a long way. I think they have a long way to go, and I think everybody acknowledges that, but very importantly, the Chinese themselves acknowledge that.

I think that's part of the thinking and the due diligence that's going to the decisions of these financial institutions to acknowledge problems, notwithstanding that the upside benefit of being involved in a country that has the kind of economic potential that China does is worth those risks.

COMMISSIONER BLUMENTHAL: Do you have a comment?

MR. JUDGE: I think John said it very well. I think they've taken a look on a very cold hard facts basis and tried to decide is it worth the risk and they see a great opportunity upside, and they're doing a lot of world-class due diligence to make that determination, and I sense from my members almost universally a desire to get more into that market, not less.

COMMISSIONER BLUMENTHAL: So would you then conclude that you as representatives of your organizations are more of the view that somehow China is going to overcome the non-performing loan problem, the substantial banking problem, and how do you reconcile that conclusion, if that is your conclusion, with what seems to be really coming out of all your testimony, that there still is a tremendous amount of desire among the government to control, whether it be financial products or others? How do you reconcile those two thoughts there?

MS. TILLMAN: From a rating agency perspective, our feeling is the more there becomes a real credit culture in terms of pricing risk and really reserving for risk adequately and understanding risk, that in itself should at least help create a discipline so that non-performing loans at least in terms of them being issued may slow down or that a credit culture would begin to exist that they ultimately stop.

I'm not going to sit here and opine as to whether the problem will go away. It's existed; it's huge. There are many different ways that non-performing loans get issued, as we heard, both formally, underground, independently, through a variety of different channels.

But certainly the more there's an understanding that people care about credit and that credit helps them in terms of managing their financial system, I think that would help at least avert to continue to increase the types of non-performing loan increases that we've seen in the past.

HEARING COCHAIR MULLOY: Commissioner Blumenthal, there will be time to come back to that if you need. Does anybody have anything they want to say quickly to that last question?

MR. DEARIE: I just wanted to point out very quickly that while your concern is well placed, and I think everybody has the same kind of concern, the Chinese have come a long way. They've got a long way to go. They are dealing with a thick portfolio of problems.

But I think in terms of trying to gauge whether or not one is optimistic or pessimistic and whether or not one is willing to risk one's own capital to go into China, I think it really does help to back up and look at how far and from where China has come starting back 15 or 25 years ago.

The very idea that China would be a member of the WTO, participating in one of the most successful rules-based legal frameworks that governs international trade, the very idea that they would be a member of such an organization as recently as 1985 or even the early '90s was a pipe dream.

It was only by way of 15 years of very difficult negotiations that the Chinese got themselves ready to become a member of the WTO. What has happened in China is nothing short of a wholesale transformation of their financial system, of their economy, of the relationship of the government and major enterprises in China. They have come a long way and they are fully committed to continuing that process.

It is a difficult process and there are problems, but I think when folks like these major financial institutions look at where China came from and the extent to which they're committed to continue that path of openness and dialogue and modernization, I think that's what gives them the impetus to risk their own capital and take a stake.

COMMISSIONER BLUMENTHAL: So it would be safe to sum up and say that they project because of what happened 16 years in the past, that it's going goes to continue six years into the future?

MR. DEARIE: I think that's part of their analysis. I think more important, though, is where they are now and how committed they are to continue the process going forward.

HEARING COCHAIR MULLOY: Thank you, Commissioner Blumenthal. Commissioner Donnelly.

COMMISSIONER DONNELLY: To follow on this subject and to present what may seem more like a statement than a question, for which

I apologize, I just have to say that there are certain not outright contradictions and certainly things that in my mind need to be reconciled before I'm willing to buy this certainty of a bright future in China.

I look particularly at your rendition of the experience of Standard and Poor's. You've been there slogging in the trenches, trying to educate people about the need for risk services for 15 years. You chose to do your own wholly-owned subsidiary in China rather than risking a joint venture with a Chinese partner to which I guess you would have been relegated to a minority position. You've been doing that for a number of years, but the bottom line, again, by what your own testimony says, is that you don't see light at the end of the tunnel. I'm sorry. I'm looking for the exact quote.

Yes, "the likelihood of receiving authorization" to operate in the way that you'd like to operate "is increasingly remote." So, where is the light at the end of the tunnel? At what point does this become an investment that might have seemed like a reasonable one going back all this way but just ain't going to pan out?

The idea that the Chinese don't understand their own best interest, which is a theme that echoes through not only your testimony but everybody's testimony, again to go back to a question that Commissioner Blumenthal posed to the first panel, there may be other things that they value besides exact financial return. I look at the quote about the McKensey study in your testimony, sir.

If they're foregoing 17 percent or $320 billion a year worth of economic growth lost as an opportunity cost because of the way they run their financial services business, whether they agree with that exact figure, they understand, as everybody has testified, they understand basically the process and the cost that they're incurring by not having best practices or the most modern set of financial services. That's a lot of dough in a developing economy. Yes, they've got a lot of baggage that they're trying to undo, but to say that they're not making a choice at this point strikes me as counterintuitive at best.

To go back not only to the WTO framework but to our own American decision to grant permanent MFN status to China that preceded WTO accession, this was supposed to be an area that we were going to be highly competitive in. Yes, we were going to perhaps suffer some losses of heavy industry and other things, which we did not have a relative advantage in, but in financial services, that's where we were going to make our money back. We're really going to crack the Chinese market wide open.

So to the degree that there is any question at all, I would say why oughtn't we to pause at this moment, assess exactly, as you say, whether

China has lived up to the specific commitments that it incurred when it signed on to the WTO process, and before we commit to a larger, deeper, longer, less precisely measured set of improved economic relations, at least say if we're going to do business with these guys in a bigger, more expansive way, the measure is have they fulfilled the very specific and relatively narrow and preliminary obligations that they incurred five years ago?

So I would like to be convinced, but it seems that this is more the triumph of hope over hard-headed business practices. I'm sorry for the screed, but--

MS. TILLMAN: If I could just correct--

COMMISSIONER DONNELLY: Okay. If you can talk me out of it or try to talk me out of it--

MS. TILLMAN: I don't think I could talk you out of it, but one thing I did want to just correct, and that is, first of all, the types of businesses that we would perform from a credit perspective, we haven't ruled out any particular option, and I think that we still have been involved very much so in working with financial institutions on improving of their credit risk management system. So there's a lot of work being done there.

In addition, to go back, what a lot of panelists have said, that 15 years ago the idea of us even sitting there and talking to them about credit, they wouldn't have a sense of what credit was. I think importantly our issue is not that the regulators don't understand what the importance of credit is.

Our issue is that there is not a unified voice, that there is a struggle between the four different regulatory bodies there in terms of who has oversight over the securities industry that is an issue for us because we do believe there's a lot of people within each of those regulatory bodies that are very well versed. They come from all over the place. They repatriated back to China from a variety of different businesses, so I just wanted to make that comment.

HEARING COCHAIR MULLOY: Fine. Thank you, Commissioner Donnelly. Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you, Mr. Chairman. A couple of months ago--this is for Ms. Tillman, but you all can jump in—there was a piece in The Wall Street Journal about an estimate that Ernst & Young made about the exposure of $900 billion in bad bank loans in the Chinese system, and the result was an attack by the Chinese government on Ernst & Young, and then a retraction by Ernst & Young that they obviously were "mistaken" in their assessment.

We may have come a long way, but there's a long political arm still associated with this government, and my question is as far as the integrity of credit agencies to make honest assessments in China, are there additional protections that will be received as a result of the accession agreements that will be in place in December? What additional protection will credit agencies get in terms of their right to be in China and do these assessments, as you understand it, in terms of this accession in December?

MS. TILLMAN: It really doesn't cover credit rating agencies. We wouldn't get any particular additional protection, and I will say to you that if Standard and Poor's does not feel that it can produce independent unbiased credit rating agencies, it will choose not to participate in the markets in China.

COMMISSIONER D'AMATO: Any follow up to that?

MR. DEARIE: First of all, your observation that, as you put it, that the political leadership has a long arm still in China, there is absolutely no question about that, and as China continues in this process of modernization and openness that will continue to be I think the nature of the struggle.

On this issue of what is really the number, the right figure, for non-performing loans, and on your point that The Wall Street Journal made regarding this struggle between Standard and Poor's or Ernst & Young and the government, I just want to point out that I think there is reason to believe that the Chinese government in some cases has not been either fully forthcoming or has underestimated the non-performing loans. I just want to point out that that's not unique to China.

Japan has been dealing with, until very recently, a terrible problem of non-performing loans that didn't happen for the same reasons. It's not that the bad loans were made for political reasons, as they have been made in China, as has been talked about here before, but they were the result of an absolutely crazy real estate market and stock market back in the late '80s and early '90s. Some very bad credits were made and there was a decade-long argument that went on between folks like Vickie Tillman's group and Western journalists and Western financial institutions and the Japanese government as to what exactly was a non-performing loan.

Not just a number but what is a non-performing loan? So I just want to make that point that getting at the true condition of the banking system, we'd like to think of it as a science. I myself am a former central banker and a bank supervisor. I can tell you that there is more art to it than you might think.

So I think one of the great advantages of this kind of foreign investment of Western financial institutions going into China and taking equity stakes in Chinese banks is that by virtue of that investment, you are importing into China the kind of credit culture, the essential credit culture that Vickie is talking about, and the requirements and the standards that these Western banks and other financial institutions are going to demand going forward when credit decisions are made at these banks in terms of the internal apparatus of credit analysis and credit control and account management and risk management, et cetera, et cetera.

So when I and others look at the situation, I am a bit more sanguine now than I was back in the late '90s, even as the number, the supposed figure of non-performing loans is going up. I think there is reason to believe that the basis of the problem in terms of the quality of lending is improving.

COMMISSIONER D'AMATO: Yes. Just one small point. I think there is a difference between a situation where there is a difference of opinion, let's say--and there's certainly room for differences of opinion between governments and companies as to the reality of the situation--there's a substantial difference between a difference of opinion and a government intimidating a Western firm into moving its conclusions in another direction. That is what I was concerned about in terms of what I was reading about Ernst & Young.

HEARING COCHAIR MULLOY: Thank you, Commissioner D'Amato. Mr. Judge, in your testimony on page four, you tell us that the foreign firms, the securities firms, your foreign ownership is capped at 33 percent, and then you tell us on the asset management sector, you're capped at 49 percent.

MR. JUDGE: That's right.

HEARING COCHAIR MULLOY: My understanding is these are the legal restrictions that we agreed to. That's what they pledged to do in their WTO. Are they fulfilling even those aspects of their WTO commitment?

MR. JUDGE: They're fulfilling those aspects of their WTO commitment. You're allowed to get up to 33 and 49 percent.

HEARING COCHAIR MULLOY: Go ahead.

MR. JUDGE: I was going to say what's slow is the approval process. There are only a few of those, and there has been a moratorium in place, unofficial moratorium in place since this spring, which probably does not violate the letter of the WTO commitment, but it is a problem for our firms in gaining access to that market.

HEARING COCHAIR MULLOY: So you tell us that even if they fully committed to carrying out these and you think they're not carrying them out in the spirit, that there's an enormous other problem, and that you can never get really full access to that market to operate as you would like to.

MR. JUDGE: That's correct.

HEARING COCHAIR MULLOY: Under their WTO agreement. So that has to be a whole new negotiation to get you that additional leverage.

MR. JUDGE: It does.

HEARING COCHAIR MULLOY: If, per chance, China had good securities firms, do they have a full right now under WTO to get full access to the U.S. financial market?

MR. JUDGE: They do.

HEARING COCHAIR MULLOY: They do.

MR. JUDGE: Yes, they do.

HEARING COCHAIR MULLOY: So there is a disparity here in what we agreed to. We don't. We're restricted there, but they can get full access here when they come to that stage?

MR. JUDGE: When they get to that point.

HEARING COCHAIR MULLOY: Yes.

MR. JUDGE: Our challenge is to try to use every lever we have to try to open up that market even more and to get them to agree to full ownership for our firms.

HEARING COCHAIR MULLOY: Yes.

MR. JUDGE: And we have to use, whether it's further WTO negotiations, bilateral negotiations, to do that.

HEARING COCHAIR MULLOY: Thank you. That's very important for us to understand how that's working because we're charged by our charter to look at how the WTO obligations are being carried out.

Mr. Dearie, The Wall Street Journal, August 15, tells us that China tells foreign banks, well, if you really want to get into this market and do yuan, you got to capitalize your branches here. Normally a bank likes to work off its world-wide capital, but they're going to tell you, you've got to capitalize each branch in China. Is that a violation of China's WTO obligations as you understand them?

MR. DEARIE: As I understand it, it is not a technical violation of their WTO obligations, but I think to answer your question, commissioner, it is a step in the wrong direction.

HEARING COCHAIR MULLOY: Why is it not? Is that because of prudential? Do they say this is a prudential safeguard?

MR. DEARIE: I think they are characterizing this as national treatment. I don't think that that is a correct interpretation. I would tend to characterize this as another example of some of the non-prudential regulatory and procedural impediments of the sort that my two panelists have been talking about to, in effect, slow down the actual on-the-ground, full taking advantage of China's commitments by Western financial institutions.

Their WTO commitment is to permit foreign financial institutions to deal in yuan, in local currency, with Chinese individuals, as of December 11, and they will meet that. But I would agree with you, that this obligation of local incorporation, which in addition to requiring separate capitalization, will also have, I think, some significant legal and tax ramifications, is an impediment to fully taking advantage of that privilege.

But, my understanding is that this proposed rule was, as you say, was circulated last week. I think it is the glimmer of hope here is the very fact that it was circulated. It is out there. The fact that it's out there will no doubt invite comment, and it's my hope that the Chinese will hear from, as I'm sure they are, from folks like Secretary Paulson, Ambassador Schwab, and Secretary Gutierrez, in addition to the foreign financial institution community, that this is a problem that needs to be addressed swiftly.

HEARING COCHAIR MULLOY: We would be very interested in your keeping us informed of that as we're going to be trying to do our own report to the Congress.

MR. DEARIE: I'd be delighted.

HEARING COCHAIR MULLOY: Finally, we're obligated under our charter to look at Chinese access to U.S. capital markets, and the extent of access and use of U.S. capital markets by the People's Republic of China. Analysts tell us that Chinese firms have been raising fewer funds in U.S. capital markets than in prior years. Is that true? That they're raising less money in U.S. capital markets now? And if so, what factors might be accounting for that?

MR. JUDGE: Commissioner, I'd want to take a look at that and get back to you on it. I don't think that's the case, but what I would like to do is to take a look at the numbers. We produce a foreign activity report every quarter. I don't have them with me. I can get that and get it back to you this week.

HEARING COCHAIR MULLOY: That would be very helpful. Thank you, Mr. Judge. We want to thank this panel very much for your help to the Commission, for coming in here and spending your time with us, and we'll recess now for lunch. We'll be resuming at 1:45, and we'll be talking about exchange rates.

[Whereupon, at 12:40 p.m., the hearing recessed, to reconvene at 1:55 p.m., this same day.]

A F T E R N O O N   S E S S I O N

PANEL III: CHINA'S MONETARY POLICY, CAPITAL

CONTROLS AND EXCHANGE RATES

HEARING COCHAIR MULLOY: I'd like to open this afternoon's panel by thanking the participants and noting that in this morning's hearing, we looked at the condition of the Chinese financial system because one of the reasons the Chinese claim they can't float their currency is because of the many problems in their financial system. We tried to get a look at that this morning.

We looked at whether China is complying with its WTO requirements in the financial services area and, Dr. McKinnon, you were here for that.

Now this afternoon, we're going to look at China's monetary policy, capital controls and exchange rates, and then in the next panel, we'll look at the macroeconomic impact of these policies on the U.S. economy. We're very fortunate on this panel to have three of the country's leading experts in dealing with these issues, and they don't always agree with each other, so it will be interesting to hear.

We'll start with Dr. C. Fred Bergsten who is the Director of the Institute for International Economics here in Washington, D.C. Dr. Bergsten had the Assistant Secretary job for International Trade and Finance at the Treasury Department at one point in his distinguished career.

He's appeared before this Commission on a number of occasions, and we very much welcome him back here today.

Our second witness is Dr. Ronald McKinnon, who is the William D. Eberle Professor of International Economics at Stanford University. Dr. McKinnon has been kind enough to come by and meet with the Commission and some of our staff on occasions in the past, and we thank him for being here today.

Finally, we have Dr. Bradley Setser, who is the head of the Global Research and a Senior Economist at Roubini Global Economics. Dr. Setser is also a veteran of the Treasury Department during the 1997 to 2001 period.

So we thank you gentlemen for being with us, and if I could ask you, we'll have Dr. Bergsten first, Dr. McKinnon second, and Dr. Setser third, and ask you to keep your presentation to seven minutes. There will be a timer and then each commissioner will get five minutes to ask questions.

So Dr. Bergsten, thank you.

STATEMENT OF DR. C. FRED BERGSTEN, DIRECTOR INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, D.C.

DR. BERGSTEN: Thank you, Mr. Chairman. I'm delighted to be back, and I will fulfill my usual function of giving you an update on the big international imbalances, China's role in them, and their implications.

The global imbalances, especially of China, have gotten much worse since I talked to you last. China's global current account surplus this year will probably hit about $250 billion, 9 percent of China’s total GDP, a pretty high number by any historical standard.

From China's internal perspective, the increases in its trade surplus have been providing about one-third of its total economic growth for the last couple of years. China's rapid growth is impressive, but a very large component of this growth is now in a sense at the expense of the rest of the world.

China is exploiting demand generated elsewhere via a sharp and steady increase in its global external surpluses. I am making absolutely no references to China’s bilateral position with the United States. I am referring to China’s global current account surplus. It has risen by huge amounts in the last couple of years. This year it will be almost a quarter of a trillion dollars, equal to about 30 percent of the U.S. global deficit, which is now approximating $850 billion to $900 billion. China is now clearly the world's leading surplus country. So point one is that the China imbalance is getting much worse, and it's central to the problem of the global imbalances. What should be done about it? What is obviously needed, and which the Chinese themselves have said they intend to engineer, is a change in the composition of their growth strategy. Nobody begrudges China's rapid growth. Indeed, China's rapid growth is a good thing for the United States and the world as a whole.

The issue is not rapid aggregate growth; it's the composition thereof. The Chinese have been relying on annual increases in their external surplus to provide a very large share of total growth these last couple of years.

It's export-led growth with a vengeance. So the strategic need for China, which is much in their domestic interest as well as a global imperative, is for it to shift from export-led growth to domestic demand led-growth, especially consumption-led growth.

One of the most stunning figures about China is that consumption accounts for less than 40 percent of its GDP, compared with more than 70 percent in the United States and more than 60 percent in India. China is a total outlier in terms of the share of consumer demand in its overall GDP. At the same time, the Chinese have a huge need for domestic social infrastructure--better health care, education, and pension programs and the like. These are a major source of domestic unrest in China's countryside, and it is a political imperative for the authorities to expand their spending and operations in domestic social infrastructure.

In addition, government investment in these areas would reduce the anxiety in the average Chinese household, which now has to provide for all its own health care, education and pensions, because there is no government safety net. Less than 20 percent of the Chinese population has any health insurance or pension plans.

As a result, precautionary savings are huge and the consumption level low. Increased government programs would not only provide an immediate source of domestic demand-led growth but also reduce the need for the average Chinese household to save huge amounts. The Chinese households would then consume more, thus fueling consumption-led growth and reducing the need to run these rapidly growing trade surpluses. So China requires this basic strategy change.

This change is clearly in the Chin's interest. Indeed, President Hu Jintao said as much when he was here in April 2006 and spoke at the White House. He said that China intends to change its strategy in this direction.

But the Chinese have done precious little to implement it. So, as in many areas, they enunciate the proper goal but don't do much to implement it. The problems therefore not only fester but get worse.

Recently, an additional element has come into the picture: Top Chinese authorities themselves admit that their economy is growing too fast and overheating. So they need to rein in domestic demand in the aggregate and at the same time need to change the composition of growth.

In this context, an economy should revalue its exchange rate. Revaluation dampens demand for exports and helps slow down the economy. It reduces the price of imports and therefore helps counter inflationary pressure. In this case, it would help resist the speculative inflow of capital--betting on revaluation, which is the main source of the rapid increase in the money supply. Such increases in money supply both add to inflation pressure and builds the non-performing loans in the banking system, thus increasing China's biggest internal risk--possible stabilization of its banking system.

So on numerous purely domestic counts, there is a very strong argument for China not only to let the exchange rate go up but also to consciously revalue it. Revaluation would be a clear part of any strategy to pursue the goals that I have mentioned which--and this is very important in political terms--the Chinese could argue was driven entirely by domestic needs.

The Chinese will not kowtow to foreign pressure. They will not give in to the U.S. Congress. They will not give in to the U.S. Treasury. They will not give into the International Monetary Fund. They will revalue because they need it internally, which in China, like any country, is important on political grounds, and I assume that would help the prospects for getting them to move in the right direction.

To keep its exchange rate from rising, China is still intervening to the tune of $20 billion to $25 billion in the currency markets each month. Their foreign exchange reserves by the end of this year will exceed a trillion dollars, amounts that are simply off the charts, in terms of the performance of any country, let alone a developing country.

So that's the problem and the strategy to respond to it. Finally, what's been happening on the ground? Chinese policy in this respect remains very, very disappointing. The Chinese engineered a tiny 2 percent revaluation of the currency a year ago. Since then, there has been no further appreciation. Indeed, they've been intervening massively to keep the rate from rising against the dollar, and since the dollar drifted down slightly in the first part of this year, the Chinese exchange rate has actually drifted down against its trade-weighted basket, thus making the competitiveness problem even worse.

The only positive note is that China is part of the new G-5, which the IMF has created under its new multilateral surveillance mechanism, along with the United States, Euroland, Japan, and Saudi Arabia. Not many people have much hope in it but as an institutional mechanism, it should help in dealing with the problem in a global context.

So the bottom line is that we still have the problem of the last three years, only that it is now worse. The Chinese surplus is huge and growing. Its importance is increasingly salient given the large U.S. deficit and the global imbalances. The surplus is importantly due to the increasingly undervalued exchange rate of the renminbi, whose adjustment the Chinese block.

There has been no effective international response, either from the IMF, or the U.S. government--except for some rhetoric from the U.S. Congress--so we remain stuck in looking for ways to persuade or induce China to start playing a responsible role in the global adjustment process.

HEARING COCHAIR MULLOY: Thank you, Dr. Bergsten. Dr. McKinnon.

STATEMENT OF DR. RONALD I. McKINNON WILLAM D. EBERLE PROFESSOR OF INTERNATIONAL ECONOMICS, STANFORD UNIVERSITY, STANFORD, CA

DR. McKINNON: Thank you, Commissioner Mulloy. Fred Bergsten and I agree that there is an imbalance and that China's very large current account surplus is due to its extremely high saving/low consumption, but it's also due to extremely low, not to say negative, American personal saving, so the two sides interact. China has done relatively little--Fred is quite right--to encourage personal consumption. We've done very little, if nothing, to reduce personal consumption, raise taxes, run budget surpluses, and do whatever you have to do maintain a balance. Fred might agree with that actually.

DR. BERGSTEN: Yes, I do. To register, I clearly agree with that.

DR. McKINNON: Where we disagree is on the exchange rate. This is not an exchange rate problem. It's a saving surplus in China, saving deficiency in the U.S. Changing the exchange rate has no predictable effect on either, and like Japan earlier when it was forced into successive appreciations of the yen from 360 to the dollar in 1971 to 80 to the dollar in 1995, it didn't have an appreciable effect or predictable effect on Japan's trade surplus measured as a share of GNP.

But it did create a terrific deflationary slump in the Japanese economy, and that's where Fred's policy would end for China if he got the really big appreciation that he wants.

Instead, monetary approach to China’s exchange rate that, in my short paper and in a longer paper that commissioners have. In both papers, I tried to show that when the exchange rate was fixed at 8.28 yuan to the dollar, roughly from 1994 to July 21, 2005, China's inflation came down from a high level in the early 1990s to a very low level by the end. In the last couple of years, it's been between one and two percent of GNP and CPI.

So as an anchor for China's monetary policy in its very high growth phase, the fixed exchange rate was brilliantly successful. Subsequently, China unhooked the exchange rate in July2005 and allowed a modest appreciation of 2.1 percent, and a subsequent upward crawl, also very modest. So on the first anniversary--July 21, 2006--the total appreciation is about 3.2 or 3.3 percent.

But, I think they unhooked for the wrong reasons: American mercantile pressure and wanting to confuse Senators Schumer and Graham regarding changing the exchange rate. However, it did have an incidental beneficial effect on China that was unanticipated: it insulated China from rising American inflation.

In 2006, American inflation has spiraled upwards and it is not certain whether Fed Chairman Bernanke can get it back under control. I think he paused too soon in raising interest rates, but we now have the American inflation rate over four percent, 4.1 for the CPI and 4.2

percent in PPI through July 2006.

In China, annual inflation in its CPI is remarkably low: one percent through July 2006. This very low rate is not the mark of an overheating economy, by the way. The rate of renminbi appreciation of a little more than three percent was just equal to the inflation differential between China and the United States. What China succeeded in doing with this gradual appreciation was to insulate itself from inflation in the U.S., which has become unduly high and is no longer so useful an anchor for China’s price level.

What are the implications of renminbi appreciation for interest rates within China? Remarkably, since China's capital controls are now very porous, international financial arbitrage has built this expected appreciation of the renminbi into interest differentials between dollar and renminbi assets.

Those of you who have my short paper and turn to the very last page will see a chart with the interest differential. For one-year Central Bank of China bonds vis-à-vis the one-year dollar interest rates (LIBOR) in London, the interest differential is about a 3.1 percent, and is a little bit more if you use short term interbank rates.

So for interest rates that are free to adjust, China’s interest rates are now three percentage points less than American rates I might say that some Chinese interest rates, such as the deposit rate and standard loan rate, are pegged. But the one-year bond rate seems to be free to adjust and so is China’s overnight interbank rate. And it is these unpegged interest rates that are now three percentage points less than their American counterparts. As you can see in the diagram, the dollar interest rate in London is 5.7 percent in comparison to 2.6 percent for the one-year renminbi bond in Shanghai.

China’s interest rates are bid down by anticipated appreciation in the renminbi. And as you can see from the figure, their interest rates were bid below American even before the actual unhooking in July 2005 because investors anticipated that appreciation would occur even before it happened. But now suppose markets consider the possibility of a much bigger appreciation of the renminbi. To be concrete, the People’s Bank of China speeds up the appreciation to six percent per year. If the American interest rate is 5.7, Chinese interest rates will be pushed toward: zero. 5.7 minus 6.0 is minus 0.3, but nominal interest rates are bounded from below by zero. You can't force them below zero.

Financial markets would immediately adjust to any expected big appreciation in the renminbi, driving interest rates down. With a lag, commodity markets are slower to adjust. But eventually, the rate of inflation in China could slow and actually become negative. China could actually face a Japan-type situation of a falling price level coupled with a zero interest liquidity trap. And once interest rates hit zero, the People's Bank of China can't do anything about it to stop the deflation because increasing the money supply can no longer affect the real economy.

It can expand as much as it wants, as the Bank of Japan did when it got into its liquidity trap, but there was no way that the Bank of Japan could stimulate the economy to stop the deflation of the 1990s. Finally, 15 years after the collapse of Japan's stock and property market bubbles in 1991, the Japanese economy is once more growing a little, with prices no longer falling. However, Japan's modest recovery is really on the back of the China boom because Japan has an export surplus with China. The Bank of Japan remains ineffective. What is my conclusion here? First of all, floating the renminbi would lead to an upward spiral in its dollar value and be a big mistake. Japan went through that wringer earlier, and it didn't work. Secondly, the People's Bank of China should pay very close attention to what's happening in the U.S. financial markets. If inflation continues to nudge upwards in the U.S., the PBC can nudge the rate of appreciation upward. If U.S. inflation slows, then the PBC should a low the rate of appreciation.

This is a very cautious monetary policy for China, but I think it would ultimately be successful in keeping the American and Chinese price levels fairly well aligned in the sense of what is called relative purchasing power parity: when the inflation differential matches the rate of appreciation. But most importantly, China could avoid importing excessive inflation from the United States [The statement follows:]

Prepared Statement of Dr. Ronald I. McKinnon
William D. Eberle Professor of International Economics, Stanford University, Stanford, CA[6]

HEARING COCHAIR MULLOY: Thank you, Dr. McKinnon. Dr. Setser.

STATEMENT OF DR. BRAD SETSER, DIRECTOR OF GLOBAL RESEARCH, ROUBINI GLOBAL ECONOMICS, AND RESEARCH ASSOCIATE, GLOBAL ECONOMIC GOVERNANCE CENTER, UNIVERSITY COLLEGE, OXFORD

DR. SETSER: I would like to thank the Commission for inviting me to participate on this panel. It's a particular honor to join such distinguished colleagues. I certainly cannot match Dr. McKinnon's

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[6] Click here to read the prepared statement of Dr. Ronald McKinnon

scholarship or Dr. Bergsten's experience, but perhaps it is fitting to have on this panel at least one member of the generation of Americans that may have to pay back some of the debt that we are now taking out from the People's Bank of China.

In 2006, China's Central Bank will likely need to buy between 250 and $300 billion in the foreign exchange market to keep the renminbi from appreciating. I'm a little bit more optimistic than Fred. I think China's reserves will top $1 trillion by the end of September, not by the end of this year.

The scale of intervention that has been required to keep the renminbi from appreciating has risen steadily since 2002. During this period, the dollar depreciated significantly against many other currencies. China's policy of resisting pressure for appreciation against the dollar, while the dollar has been depreciating against many other currencies, has contributed to a phenomenal surge in China's exports.

In 2002, China exported around $325 billion worth of goods. In 2006, China is on pace to export about $950 billion in goods, roughly as much as the United States. It's an extraordinary increase and clearly has been propelling the large increase in China's current account surplus that Dr. Bergsten mentioned.

China's de facto dollar peg has profound implications for the Chinese economy, for the U.S. economy and for the global economy. China's peg has favored China's export sector including the operation of foreign multinationals that have invested in China over other sectors.

As exports have risen as a share of Chinese GDP and as more and more components are produced inside of China, China's exposure to the global economic cycle is increasing, a potential source of vulnerability. Perhaps even more importantly, China's Central Bank has kept domestic interest rates, as Dr. McKinnon noted, below U.S. rates in order to discourage capital inflows and to try to limit the pace of Chinese reserve growth.

There is consequently a growing risk that China's efforts to defend an undervalued exchange rate have led it to set domestic interest rates at levels that are too low for its own economy.

Preventing the ongoing increase in China's reserves from leading to faster than desired money and lending growth has been a constant challenge for China's authorities. The People's Bank of China has withdrawn many of the renminbi it sells for dollars in the foreign exchange market through the sale of sterilization bills.

But China has not successfully sterilized the full extent of its recent reserve growth, leading to a build-up of liquidity inside the Chinese banking system. Keeping the banks from lending their spare cash from their rapidly growing deposits out and fueling even more rapid growth in Chinese investment has required the growing use of administrative controls and in some ways has set back efforts to liberalize China's financial system.

China's de facto peg to the dollar also has profound implications for the U.S. economy. It has favored interest sensitive sectors of the U.S. economy over sectors that compete with Chinese goods and over sectors that could potentially export more to China.

China's purchases of U.S. securities have kept U.S. interest rates lower than they otherwise would have been. I would estimate by at least 30 basis points and perhaps by more. They are one reason why job growth has been concentrated in sectors tied to the housing market.

China's de facto peg also complicates the process of global adjustment, as Dr. Bergsten has emphasized. China now has one of the world's largest current account surpluses, yet its currency is tied to the currency of a country with a very large current account deficit. Correcting China's surplus requires the renminbi to appreciate. Correcting the U.S. deficit would be far easier if the dollar depreciated. Yet, so long as the two currencies are tied together, movements in the dollar become movements in the renminbi.

One of the surprising facts about the contemporary world economy is that China's current account surplus has increased in line with the current account surpluses of the world's oil exporters, and we know they have a lot of money with oil above 70 a barrel.

This has meant that Asia's overall current account surplus, taking into account all Asian countries, Japan and China included, has not fallen, even as the oil exporters' surplus has soared. In equilibrium, a rising surplus in the oil exporters and a constant to rising surplus in oil importing-Asia requires that other oil importing regions, notably the United States and Europe, run larger current account deficits. Until recently, almost all the increase in the deficit has come from the United States.

I want to conclude by emphasizing four points. First, the available evidence strongly suggests the renminbi is significantly undervalued. China's basic balance, its combination of its current account surplus and foreign direct investment, is around ten percent of its GDP. The United States' deficit in the same measure is around eight percent of its GDP.

Moreover, I think it's reasonably clear that the large depreciation of China's currency against many other currencies, not the dollar, has contributed to its extraordinarily rapid pace in export growth. We have some evidence about the impact of changes in the renminbi on trade. Just look at the surge in Chinese exports to Europe. Chinese exports to Europe have been growing faster than their exports to the U.S.

Second point is that China intervenes in the foreign exchange market and also maintains strict controls on the flow of capital. We don't know for sure what would happen if China stopped intervention and eliminated all administrative controls. But right now, even with those controls, it is clear that more money wants to get into China than wants to get out.

Third point, China's rapid reserve growth has significant impacts on U.S. financial markets. Roughly 70 percent of China's one trillion in reserves is now invested in U.S. securities of various kinds, and China is adding roughly 150 billion to its portfolio every year. That has significant impact on interest rates in our markets.

Fourth, last, renminbi appreciation, as Dr. Bergsten has mentioned, and I think Dr. McKinnon would agree, is only one of many policy changes needed to reduce China's current account surplus. The recent surge in Chinese savings, according to evidence from the World Bank, hasn't come primarily from a surge in household savings. It has come from rising government and business savings. Consequently, I think it's important that measures to lower Chinese savings include steps beyond simply expanding China's social security system, which is vitally important, but also including greater distribution of business profits.

Last, it is important to recognize that China is only one of many countries with large current account surpluses. The oil exporters also have large surpluses. Many other countries in Asia as well. China is an important, but it's not the only important, surplus country, and it's vitally important to recognize that the U.S. Congress has far more control over the policies adopted by the world's largest deficit country than over the policies adopted by the world's surplus countries, and that the credibility of our efforts to change policy abroad will hinge on the perceived willingness of our own government and this Congress to make policy changes here.

Thank you.

[The statement follows:]

Prepared Statement of Brad Setser, Director of Global Research, Roubini Global Economics, and Research Associate, Global Economic Governance Center, University College, Oxford[7]

Panel III: Discussion, Questions and Answers

HEARING COCHAIR MULLOY: Thank you, Dr. Setser. This was a terrific panel. I want to thank each of you for your testimony.

[7] Click here to read the prepared statement of Dr. Brad Setser

Chairman Wortzel.

CHAIRMAN WORTZEL: I appreciate your testimony as well, although I think you'll all or the three of you will agree that it's contradictory.

DR. McKINNON: Two to one.

CHAIRMAN WORTZEL: Two to one. Yes, it is two to one. But, Dr. McKinnon, if our interests on this Commission are in the U.S. economy, I'm still not clear on why the United States should be concerned if the Chinese interest rate would be pushed to zero if the currency doesn't float. What effect would that liquidity trap have on the U.S. economy? That's a China problem, but I'm not interested in making the Chinese economy stronger. I'm interested in making sure the United States is stronger.

DR. McKINNON: It is not in our interest to have an economic collapse in China. After all, it is a nuclear power as well as having many still-poor people. If because of expected and actual appreciation, China faces severe deflationary pressure and an actual fall in the price level, as Japan did earlier, this would cause economic distress. And once the interest rate hits zero, the central bank can't do anything about it. It can't reinflate the economy. It can expand the money supply by almost any amount with no expansionary effect because the interest rate is trapped at zero. That was the trap the Japanese found themselves in the 1990s.

Then there's a secondary effect. When you compress market interest rates toward zero, and China finds it increasingly difficult to maintain officially pegged deposit and loan rates above zero, that takes away the natural profitability of the banks. As with Japan earlier, the spread between deposit and loan rates narrows so that the banks can’t generate enough retained profits to write off their non-performing loans. CHAIRMAN WORTZEL: In China?

DR. McKINNON: With very low interest rates, it is much harder for banks to grow out of a bad loan situation. In the 1990s, remember how Japan’s banks could never seem to grow out of loans that had become nonperforming with the collapse of their real estate bubble in 1991. When interest rates on new loans were pushed toward zero, there was no ongoing flow of profits in the banks against which they write off their bad loans. China could get into that situation, too.

Instead, China should aim for a stable exchange yuan/dollar rate that keeps domestic and interest rates at international, i.e., U.S. levels. The only modification to this stable exchange rate policy would come if U.S. inflation became too high as is true currently. Then, and only then, should the renminbi appreciate modestly.

CHAIRMAN WORTZEL: Does that assume that like Japan's yen, that the yuan or the renminbi floats? Does the fact that doesn't trade, that it's a closed currency have any effect on your position?

DR. McKINNON: The argument I was making assumes the capital controls are quite porous so this international arbitrage pushes Chinese interest rates below American by the amount of the expected appreciation. But if you look at Japan's interest structure at the moment--I'm sorry to deflect you--the short-term Gensaki rate in Tokyo is only .25 percent, and the long rate is only about 1.7, or 1.8, very low. So, you might ask, well ,if the Japanese yen hasn't appreciated net since 1995, why the huge interest gap? Why in 2006 don't international arbitragers bid Japanese interest rates up to American levels?

In that long paper I gave you, there is an explanation. Although the yen hasn't appreciated net since 1995, it has fluctuated like a yo-yo since then. And because of past Japanese trade surpluses, Japan's insurance companies, banks, and so on, are chock-full of dollar assets. That's a big source of risk for them if the yen/dollar rate fluctuates. Because their liabilities to Japanese policy holders are in yen, an insurance company could be bankrupt if the yen appreciates randomly, if only temporarily, and so reduces the yen value of its dollar assets. So Japanese financial institutions demand a much higher yield on "riskier" dollar assets than on yen assets. But with U.S. interest rates determined exogenously in international markets, and you can only get that when the yield on yen assets is pushed towards zero. Having a floating exchange rate with substantial fluctuations even with no net long-term appreciation, is bad if you are a dollar creditor.

CHAIRMAN WORTZEL: For them?

DR. McKINNON: Yes.

CHAIRMAN WORTZEL: What do I care about them? How about for us?

DR. BERGSTEN: Mr. Chairman, could I give you the easy answer to the McKinnon problem? I agree with him that it would be a mistake for China to float the currency now because of instabilities in its banking system. But he's worried about a gradual appreciation of the renminbi because it would set up expectations of a continued rise in the renminbi, which would then create the interest differential that he worries about.

DR. McKINNON: Has created

DR. BERGSTEN: Has created and could continue to create. The simple answer is a large one-shot revaluation. If you could find the right number, 25 or 30 percent, China would announce it tomorrow and revalue: there would be no expectation in the market of further rise in its currency and therefore no deleterious effect on the interest differentials that he worries about. True?

DR. McKINNON: Right. If it was a complete surprise appreciation, which is unlikely.

DR. BERGSTEN: No. If they did it tomorrow, it would be a huge surprise.

DR. McKINNON: But they just heard you today, Fred.

DR. BERGSTEN: Well, we'd all raise a glass and toast.

DR. McKINNON: There's a man from the Chinese press sitting right over there.

DR. BERGSTEN: But it would still be a huge surprise.

DR. McKINNON: Yes, but--

DR. BERGSTEN: But that would solve your problem; would it not?

DR. McKINNON: No, it wouldn't because the second part of it is that that appreciation would not reduce China's trade surplus.

DR. BERGSTEN: There we differ.

DR. McKINNON: It would cause a slump in China and a reduction in its imports to match the reduction in their exports, just as happened to Japan. So Americans then with the same faulty elasticity model of the balance of trade in their head would say, oh, look, your surplus is continuing, you guys didn't appreciate enough. That's what we used to say to Japan in the Japan-bashing days. So that one is not going to work.

DR. BERGSTEN: Would that be right if they simultaneously expanded domestic demand the way Brad or I suggested?

DR. McKINNON: Yes, they should just expand--

DR. BERGSTEN: Because they can offset that by increasing domestic demand.

DR. McKINNON: Just expand domestic demand, period. Don't touch the exchange rate. Americans should raise domestic saving, period. Don't fiddle with the exchange rate.

HEARING COCHAIR MULLOY: This is exactly what we hoped would happen, a good discussion like this. But I would like to let it go on, but other commissioners have questions. So let's go. Commissioner Reinsch.

COMMISSIONER REINSCH: I just want to follow up on that exchange in one respect. I think in general I'm more persuaded by Fred's arguments, but I would like him to comment on one thing that Dr. McKinnon said in his testimony, not in the most recent exchange, which was the precedent of Japan. I know many of us, including you, Fred, gave many speeches in the '80s and '90s saying if the yen were just 250 and then 150, all our problems would be solved, and as Dr. McKinnon pointed out, that's exactly what happened and all of our problems haven't been solved, at least as far as the trade deficit there is concerned.

I think he's suggesting that were the same thing to happen with the Chinese, there might be much less of an effect than you're projecting. Can you comment on that?

DR. BERGSTEN: Sure.

COMMISSIONER REINSCH: Why is he wrong?

DR. BERGSTEN: In Japan’s case, its current account position changed substantially as a result of the exchange rate change that took place during the period. When the yen underwent its substantial appreciation, after the Plaza Agreement in 1985, it rose about 50 percent in value against the dollar over the next two to three years.

By 1990--91, both the Japanese global surplus and the American global deficit virtually disappeared. Those adjustments worked like in a textbook. Meanwhile, the U.S. authorities fell asleep at the switch again, the yen started weakening again, and Japan’s surplus started rising.

So we went back to imbalances. Indeed, that led to the fluctuations of the exchange rates in the '90s, but the point is that the current account adjustment worked just like in a textbook.

My second point is that--Ron blames the currency appreciation for the collapse of the Japanese economy in the '90s. That's ridiculous. The Japanese financial system was incredibly faulty, full of non-performing loans, and had all sorts of keiretsu and integrated relationships among the banks; supervision was inadequate; the Ministry of Finance had political control over it; and there was no independent central bank. So these were the underlying problems. First the bubble, and then the collapse of the bubble.

As for the international side, what set the bubble up in the late 1980s was that the Ministry of Finance realized that Japan needed to expand domestic demand to offset the big decline in its trade surplus that eliminated the current account surplus; Japan needed to offset that by an increase in domestic demand.

The Ministry of Finance worried about fiscal stability in Japan and controlled monetary policy so it ordered the expansion to occur through easy money. The easy money in turn created the housing bubble and the other bubbles in Japan, which inevitably burst for the usual reasons seen in country after country.

Since the Japanese financial system was so replete with non-performing loans and lacked adequate supervision, it took Japan a decade to get out of it. Once they got serious about it, under Koizumi and with Heizo Takenaka running the Financial Services Agency, the Japanese cleaned up the banking system in two or three years, and now the economy has begun to grow again.

COMMISSIONER REINSCH: Well, I want to give Dr. McKinnon a shot. Before that, since you have all prescribed increasing Chinese domestic demand and Chinese consumption as part of the remedy here, what do they need to do to avoid the Japanese problem that you just described?

DR. BERGSTEN: China like Japan has a big problem in the banking system. It has huge non-performing loans. But it has begun to address it.

COMMISSIONER REINSCH: Yes, but in terms of expanding consumption or promoting consumption, how can they avoid the Japanese trap that you just described?

DR. BERGSTEN: By a more balanced stimulus from fiscal as well as monetary policy, which China, unlike Japan, fortunately has a lot of scope to do. By the mid 1980s or so, Japan already had a huge national debt and big budget deficits. That's why the Ministry of Finance wanted the expansion to come through monetary policy.

COMMISSIONER REINSCH: Good point.

DR. BERGSTEN: China has very little domestic debt and a very strong fiscal position. In my original remarks, I was advocating that China achieve the domestic demand expansion in the first instance through increased government spending on social programs. I argued that it would also create additional private consumer demand because it would reduce the need for precautionary saving and raise China's miserably low national consumption ratio.

So that's a fundamental difference. Second is the starting point. Ron says I'm going to drive China into deflation and recession. Well, China is coming off a base of 10 to 11 percent growth. It would be very hard to drive China into recession even if you made every effort and used every policy instrument known to mankind to do that.

You might reduce China's growth from 10 or 11 percent to 8 percent, but indeed that's what its leadership says it wants to do. They say the economy is growing too fast. They're creating excessive capacity. There's excessive investment in the economy. One of the objectives of the adjustment program would be to slow the aggregate growth rate. It would still be 8 percent. It wouldn't be deflation. It wouldn't be recession. I would have very few worries about what that would mean for the world economy and the United States.

COMMISSIONER REINSCH: Can we give Dr. McKinnon a chance to respond? I'd like to have him respond not to the question, the domestic Japanese policy issues, but to the first point that Fred made about the history of the late '80s and early '90s.

DR. McKINNON: Well, I'm sorry to leave Japan, but on this last point that Fred made, if you had a large appreciation, that would slow down the Chinese economy. There is no doubt. We agree on that.

DR. BERGSTEN: Yes. Part of the objective.

DR. McKINNON: But where the slowdown would be biggest is in investment. We have pretty good evidence when a country appreciates discretely, then multinational firms and domestic firms see that as an expensive place to invest and they'll invest less. They look for countries that are more undervalued.

So the slowdown in China would probably be led by an investment slowdown. Now, it turns out that, as an accounting identity, the current account surplus is simply the difference between saving and investment. If you create an investment slump in China and saving stays high, the current account surplus will increase; right? That could be the perversity of a sharp rise in the renminbi.

In addition, insofar as some of the dollar assets are held privately within China, a sharp appreciation of the renminbi will diminish the wealth of people holding those dollar assets. So that will be another negative downward force on China's economy and again offset the effect of the appreciation.

So even though the appreciation slows exports, the slump—particularly the investment slump--slows imports, thus you have complete unpredictability as to what would happen to China's surplus. The only thing that's predictable would be that Americans would remain unsatisfied because the trade surplus remains so big. They'd come back and say, oh, you haven't appreciated enough.

COMMISSIONER REINSCH: I'd like to go on, but my time is up. Thank you.

HEARING COCHAIR MULLOY: Yes.

DR. BERGSTEN: It's really important to respond to a couple of those points.

HEARING COCHAIR MULLOY: Yes, you'll have an opportunity because I think it's important. Commissioner Wessel.

COMMISSIONER WESSEL: I'll give you some of my time after I raise a question and then throw it open. Fred, you talked about needing a one-time big change, that would probably be the best approach, if I heard you correctly.

We have the Schumer-Graham bill that if it were to pass in the fall, we presume that the president would veto it. Dr. McKinnon, I think you, unless I'm misquoting, you indicated that we need to change consumption patterns here and a tax increase or some fairly dramatic policies might be appropriate, but I don't think any of us see those occurring in the next couple of months if not years.

Where does that glide path take us? The public has believed from the theoreticians that over time exchange rates would help equal all of this out. That's not working. Are we going to continue to see rising current account surpluses with China, a deteriorating position here, and as a result, the need sometime in the not too distant future for even more dramatic policy changes? Any of the witnesses.

DR. McKINNON: What you're describing is a trap. We're trapped. It's not easy to get out of it. There isn't an exchange rate solution. There's the hard solution that we should reduce demand in this country, run with fiscal surpluses, encourage much higher private saving, maybe through forced saving programs for households, but then China has to take some action to get its households to consume more.

Those are the hard things to do. Now China is so much of a market economy that the government can't just pull strings the way they used to. But it would be bad to reach for the wrong instrument, which is the exchange rate. Now, might you say, can these imbalances go on forever?

Well, maybe in my lifetime actually. I'm not sure about yours.

DR. SETSER: I certainly hope they don't last my lifetime.

DR. McKINNON: We used to have this sort of conversation back in the early 1980s. If you remember the twin deficits under Ronald Reagan, they became much bigger than anyone had ever thought possible, and people would sit around saying, “This can't last can it?

DR. BERGSTEN: And it didn't.

DR. McKINNON: Now, that gives me an opening.

DR. BERGSTEN: It didn't.

DR. McKINNON: In 1991 there was a temporary balance in the current account. I think there was one quarter when the current account deficit touched zero. This happened during the severe credit crunch of 1991 when the American economy turned down and George Bush lost the election in 1992. We all remember that. And the turndown in the economy reduced imports sufficiently to restore temporary balance in the current account.

But the key issue is: What caused the credit crunch of 1991, high long-term interest rates, and subsequent downturn in the U.S. economy. There were two external shocks, which by accident coincided, and combined to suddenly cut off foreign capital inflows into the saving-deficient U.S. economy.

The first was the collapse of the Japanese bubble in stock market and land prices in 1991. Suddenly, the huge flow of long-term capital from Japan into the U.S. capital markets ended. In U.S. real estate markets, there was distress from Hawaii to Los Angeles to New York as long-term interest rates rose relative to short term. The second exogenous event that happened in 1991 was German reunification.

West Germany had been the other huge lender (the second biggest into the American financial markets. With reunification, this flow of finance was suddenly diverted into East Germany. Suddenly Germany went from a large current account surplus to a current account deficit. Thus, in 1991, did the U.S. suddenly lose its two principal external sources of finance. This uncovered U.S. fiscal deficit. As long-term interest rates rose, U.S. banks began to buy government bonds and reduced their lending to business for working capital—whence the "credit crunch." Although unlikely to be repeated in this precise way, this episode is very instructive. It is most unwise for the American government to lean on foreigners to reduce their current account surpluses when American itself has a savings deficiency. If we take away the external finance while we have very little personal saving and a large government fiscal deficit, then it would generate another credit crunch in the U.S. economy.

COMMISSIONER WESSEL: Dr. Setser, since you haven't had much chance.

DR. SETSER: Yes, I would like to comment on this particular issue because I think what many people underestimate is the extent to which changes have to happen just to maintain the status quo. And by that the current trend is not for the current account deficit to be constant; it is for the current account deficit to rise over time.

So the status quo is not a seven percent of U.S. GDP current account deficit. The status quo with a normal rate of U.S. growth is a rising current account deficit. Mathematically, the current account deficit is the sum of the trade deficit and the income balance, and the U.S. income balance has been artificially held down by the very low interest rate that came about because of the low Fed funds rate. That is in the process of changing.

So if the trade deficit were simply to stabilize, the current account deficit would continue to rise because no longer will a rising net external debt be offset by falling in average interest rates.

So as much as China would like to be able to rely on export growth, as Fred mentioned, and continue to propel exceptionally rapid increases in its economy, over time, at the minimum, trade will provide less of a stimulus to the Chinese economy simply because the U.S., the counterpart, can't continue to have an ever-growing trade deficit, and eventually over time, just keeping the current account deficit stable at six percent of U.S. GDP requires the trade deficit to fall back to three percent of U.S. GDP as our external debt continues to rise.

And I am quite convinced, that will have profound implications for China, and that's why I think we all agree that the basis of Chinese growth has to change substantially. And I would say China's high savings rate presents an opportunity. It implies that consumption is very low and, yes, investment is going to have to fall in China, but the core challenge is to get China's consumption rate from 40 to 60 percent of its GDP.

HEARING COCHAIR MULLOY: Commissioner D'Amato. Thank you, Commissioner Wessel.

COMMISSIONER D'AMATO: Thank you, Mr. Chairman, and thanks very much to the panel. You have been very illuminating. I want to focus on the question of the Chinese mentality here. What really do you think it is that the Chinese are stopping the Chinese from readjusting their RMB? Why are they insisting on keeping it at this level, particularly if Mr. Bergsten is correct, that they recognize that a reduction in growth as a result of a change in this export strategy would be to their benefit?

Let me suggest one possible theory. You mentioned, Mr. McKinnon, the question of investment. It seems to me that what the Chinese covet the most from this flow of investment is American high technology. That technology is where the future is, and it comes with American investment, and of course they adopt it in various ways, this technology. Would it not be the fact that they would fear the reduction in the flow of investment and therefore the availability of high technology as the impact that the increase in the RMB would bring?

I haven't gotten a sense as to what it is that they are really afraid will happen if the RMB were to go up, let's say, 25 or 30 percent increase, as you say, on a short-term basis. What is it that they're afraid of, do you think? Fred?

DR. BERGSTEN: They're afraid of a lot of things. You're correct in pointing to the fear that China might be a less attractive destination for foreign investment. Analytically, however, that's correct only to the extent that the foreign investment is motivated by taking advantage of the undervalued renminbi for export purposes.

A lot of the foreign investment is, of course, now serving the huge, rapidly growing Chinese domestic market. That would not be adversely affected. The appreciation might even strengthen the economy and its sustainability.

What China particularly likes from the foreign investment inflow is technology, but you stressed American technology. Keep in mind that less than 10 percent of the direct investment going into China is from the United States.

COMMISSIONER D'AMATO: Yes.

DR. BERGSTEN: Most of it from the rest of Asia.

COMMISSIONER D'AMATO: Well, technology in general.

DR. BERGSTEN: The broad point is correct. A series of very simple things is what motivates them. They've had a model that's worked. They haven't run into much static despite all the talk about it from the rest of the world. They get away with it.

Ron really misleads you when he suggests that their currency policy is dictated by trying to find a monetary anchor. I don't think that is the case at all. It's an off-budget job and development subsidy, which enables them to under price their products in world markets, thereby enabling them to export some of their unemployment to the rest of the world, and take huge advantage of the currency misalignment.

Now, if it has a spin-off favorable effect on monetary policy, then that would be well and good. But it hurts their monetary policy because it generates speculative capital inflow. Such inflows make it harder to maintain stable growth of money supply and that adds to the build-up of non-performing loans, which increases the vulnerability of the banking system. So it's a thoroughly bad thing for China or any other country to maintain a severely undervalued currency. It fouls up a country's monetary policy, far from strengthening it, like Ron thinks.

But what motivates them is that it's an off-budget export, job and development subsidy. They don't have to account for it domestically because they don't mark to market. Even if they pile up a trillion dollars in reserves and take a 40 percent loss on it, as they surely will over the next decade, nobody is going to call them to account for that.

Likewise, you get away with it internationally because, despite IMF rules to the contrary, nobody enforces the currency manipulation problem. So it is the manna from heaven policy tool. You have no accountability domestically. You have little push-back internationally. And it achieves many of your purposes. So why get rid of it unless there is a compelling reason?

The current Chinese leadership is the most risk averse China has had in decades. They've got a Party Congress coming a year from now. They're particularly risk averse right now. If it ain't broke, don't fix it. That's how they view the situation. It's not too much more complicated than that.

COMMISSIONER D'AMATO: Mr. Setser, and the obverse or the reverse of the job growth, of course, if they lost that, then they might fear some question of some domestic stability in some regions.

DR. SETSER: I think the argument that China's exchange rate policy has fueled extraordinarily rapid job growth inside China is somewhat overstated. If you look at the actual job growth numbers, Chinese job growth hasn't been fundamentally impressive, and I think one of the reasons why its effect on domestic job growth has been a little bit more ambiguous is that interest rates are so low, so strangely enough even though China has this enormous surplus of labor in the world in agricultural regions, it makes sense in a lot of cases to substitute capital for labor, which shouldn't be happening at this stage in China's development process.

So I'm not convinced it's fundamentally achieving China's full objectives, but I think I agree with Fred, hey, it happened, and the exchange rate went down, exports went up, China is booming, why change? Moreover, the benefits of that policy are extremely front-loaded, as Fred has mentioned, lots of investment, lots of export growth, booming property prices in the big cities. There are lots of domestic interests in China that benefit from all this.

The costs are extremely back-loaded--the loss of the value of your foreign exchange reserves over time, paying the taxpayers, picking up the bill for all the NPLs, the over-investment in some sectors of China's economy.

So if you combine front-loaded benefits and back-loaded costs, well, that's a policy that appeals to a lot of people in this country, too.

HEARING COCHAIR MULLOY: Thank you. Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you all for your testimony. I went over Dr. Setser's again to follow up on some of the so-what questions that I think Chairman Wortzel was getting at. So what for the American economy?

Let's assume for purposes of argument that Dr. Bergsten's initial testimony that the Chinese haven't done much in terms of moving to consumption-led growth will continue, that all this great advice we give them, they're just going to continue along the same lines and not move to a consumption-led growth model, and they like how things are going now, and they're not going to change, they're not going to revalue.

Dr. Setser, you have in your testimony a number of policy suggestions that the Chinese could take to raise the share of consumption, but again let's say. for argument sake, this does not happen.

One of the things that is striking in your testimony is that you say that part of the problem in general is the banking problem, one of the problems with the imbalance is also the banking problem, and you say that in order to fix this, they'd have to tax heavily their population or that would be one way to bail themselves out of a non-performing loan problem.

But that would go against, for example, the goals of creating more consumption, wouldn't it, just so I understand? A heavy tax on the population in order to deal with the NPL problem would not lead to a consumption-led economy; is that correct?

DR. SETSER: I think that's correct. I actually believe that China's central government should run a larger fiscal deficit. I think Dr.

Bergsten agrees with that, and what I think they should do is instead of having non-performing loans on the books of various state banks, they moved many of them off the books to various asset management companies, but the banks when they moved the loans off the book are left with a bond that's been issued by the asset management company, and the asset management company actually has no effective assets to back that bond.

So it's effectively an implicit liability of the Chinese government. I think that implicit liability should be made explicit, turned into a government bond, and then instead of taxing the Chinese population to pay interest on that bond, just borrow the money.

China's saving rate is very high. There's plenty of spare savings inside China to finance a small fiscal deficit.

COMMISSIONER BLUMENTHAL: Do you think there's a significant tradeoff between moving to a consumption-led economy versus dealing with the banking problem? Or is not as distinct a tradeoff as I'm portraying it?

DR. SETSER: I don't think there's a distinct tradeoff. I think taking some of the non-performing loans off the banks' balance sheets frees up their balance sheet to make other kinds of loans, and if the incentives are right, then can shift to, and they are shifting to more mortgage lending, to more consumption lending. I don't honestly think there's a significant tradeoff there.

COMMISSIONER BLUMENTHAL: To get to Commissioner D'Amato's question, do you think that the Chinese think that there's a tradeoff?

DR. SETSER: I think the Chinese in all honesty are scared. I think they believe, and this will give me a lead-in to Professor McKinnon, I think they believe in some of what Dr. McKinnon says.

If you're investing 50 percent of your GDP, and investment has been growing as your share of GDP, you're a little bit scared about anything which might lead that situation to change. You may recognize that it's good long-term, but in the short-run, it's uncomfortable, and there will be an uncomfortable period should investment slow. There's a difficult balance. As investment slows, you need consumption to take over as the driver of growth, and managing that transition is going to be difficult.

DR. McKINNON: Yes. There's a young man, Nicholas Lardy, who works with Fred and studies China very carefully. He's always complaining about the unsustainable high level of investment in China. But of course, if you reduce investment with the high saving, you get an even bigger trade surplus, so there is a trap there.

There's no way out but for China to try to increase consumption, and some of it should be social consumption of the sort that Fred mentioned. But cutting taxes on Chinese households and businesses is not that simple. A big problem with China's earlier move toward a market economy was that their tax revenue fell so sharply as a share of GNP. From 1978, at the beginning of the market period, to 1994, it fell from 33 percent of GNP to 11 percent.

This is one reason the Chinese have so many bad loans in their banking system. When government revenue fell so sharply, the central, provincial, and local governments, all leaned on the banks to make special loans that were not economic, but rather for social purposes. Now, China has recovered--

COMMISSIONER BLUMENTHAL: I see that I'm running out of time, and I wanted to get to one last question for Dr. Setser.

DR. McKINNON: China's recovered its revenue position, and so it's in a better shape now.

COMMISSIONER BLUMENTHAL: Yes. The last question, which was my lead-in, which is what if they don't take any of this advice, how does it affect the American economy? You basically say that right now they're affecting sectors of our economy by essentially favoring certain sectors, mortgage-backed securities and so on.

Let's assume they don't take any of this advice, and they continue on, what happens to our economy?

DR. SETSER: I think they will continue to favor the sectors that are currently being favored, but the impetus that they will deliver to the mortgage market will probably decline, and so that the same policy won't deliver the same degree of stimulus that it has in the past, but broadly speaking, it will favor the housing sector and other interest-sensitive sectors. It will penalize sectors that compete with Chinese production, and as more and more types of goods are produced inside China, the set of sectors that are affected is likely to expand.

I think you guys have been to Michigan. I think the auto parts sector is--

HEARING COCHAIR MULLOY: Exactly. That was the point I made in my opening testimony that this favors the interest-sensitive, the housing market and other things here at the expense of our manufacturing firms that have to meet the competition from these imports from China that get an impetus from the undervalued currency. So that's a very important issue as we saw it out there in Michigan.

Commissioner Donnelly.

COMMISSIONER DONNELLY: Thank you, Mr. Chairman. Thank you to the witnesses. Since in many ways, my question has been asked by people prior to me, I'm still going to ask them again because it's my turn. I would actually like a more complete answer, particularly from Dr. McKinnon, and I am more interested in your guesses about what the Chinese will do rather than what they ought to do, whether it's a shocking revaluation or creation of a larger consumption economy. Each one of those has a certain fantastical what if Eleanor Roosevelt can fly dimension to it.

So I'm more interested in your description or guess as this process goes forward. As you look at the Chinese economy, which way are they most likely to jump in this regard or will they just continue to play the kind of incremental game, as Dr. Bergsten said, favoring the status quo is pretty good; let's not mess with it until something catastrophic happens?

So what will the Chinese do? If this can't go on forever, presumably it won't.

DR. BERGSTEN: Since it's worked very effectively for them, and they've gotten away with it internationally, there's a lot of incentive to stick with what they’re doing, at least until they get a lot more heat for doing it.

There are two sources of pressure for change in policy in any country at any given time. One is from the market. The Chinese have at least enunciated that they are growing too fast and need to rein in the growth somewhat for fear that it will produce excess capacity and a subsequent bust, that it will at some point generate more inflation, as it did a couple of years ago and was later tamed, or that it will lead to a big foreign repercussion.

But the second source of pressure is the outside world. The Chinese have insulated themselves substantially from external crises through capital controls. Porous as those controls are, China is not going to be subject to an Asian type crisis of ten years ago because, first, they're a huge creditor, but second there's no prospect for large withdrawal of foreign capital.

So they've insulated themselves pretty well on both the domestic and international sides, and the path of least resistance is to continue the status quo for some time in the future.

COMMISSIONER DONNELLY: If I could add one more dimension to the question. Previous panels have suggested when there's been a sort of anomaly, in the sense that the Chinese don't act in a perfectly economically rational way when it comes to financial markets or the banking system, for example.

Previous panelists have testified that, in fact, Chinese experts do understand the problem, but it's just that the political internal domestic political choice is too hard. Would you accept that analysis as it applies to--

DR. BERGSTEN: Yes. But I would put in one caveat. Chinese officials, as well as the public more broadly, do understand what we're saying and the arguments in favor of doing that, so at some point there could be some change. One of the problems is that the top Chinese political leadership is ultra conservative and faces a Party Congress a year from now. The top governing body, the State Council, does not understand these issues, and the fact that what they're doing seems to be working fine is strong counsel for sticking with it unless there is some really major pressure not yet observed to make some change.

COMMISSIONER DONNELLY: Time for others? I've got 30 seconds.

HEARING COCHAIR MULLOY: You've got 30 seconds.

COMMISSIONER DONNELLY: Either one of you fill up the time? Please, if you've got any predictions about what the Chinese will do, go ahead.

DR. McKINNON: One must remember that China is now essentially a market economy, and the State Council has less influence than you might think. Today, Chinese officials could be sitting around a table like this worrying about what to do about their very high saving and inadequate consumption and not knowing quite what to do about it. It's a little like U.S. realizing that Americans are over-consumers and under-savers, but with no consensus on a new economic policy.

But Fred used the term, China's "got away with it" now for two or three years. Why say "get away with it?" The world economy has never been in better shape, right? We've had two golden years of very high growth. Nobody is hurting. Even Latin America is growing modestly.

DR. BERGSTEN: It's great to live on those credit cards. As long as nobody calls in the balances.

HEARING COCHAIR MULLOY: Absolutely.

DR. BERGSTEN: China is about half a market economy now. It is certainly not a complete market economy, and people who study the composition of the Chinese economy conclude that China has let the periphery go to market forces, but has maintained control of the core of the economy including the key sectors through the command and control mechanism.

Now, to China's credit. I've been critical of China, but I want to defend them in an important sense: I think they have game plans for continuing to marketize the economy, for continuing to move from farm to modern sector, which increases productivity 16 to one. Every time somebody moves from the farm to the modern sector, it improves productivity 16 times.

They have a clear strategy for continuing to phase down the state-owned enterprises into private enterprises, which also adds to productivity. That's why I think the fear that Ron conjures up of China falling into deflation or recession is a fantasy. They Chinese have got so many sources of continued rapid productivity growth that they will enjoy another decade or so of very rapid economic growth.

True, there could be a political upheaval. True, there could be a banking upset. We went through every possible risk to the Chinese economy in our new book, a copy of which I have brought for you. On balance it looks like pretty strong continued sailing for the Chinese economy for the foreseeable future.

HEARING COCHAIR MULLOY: We better move on.

DR. McKINNON: Yes. Fred is talking about China now the way we talked about high-growth Japan in the 1980s, just before it got hit over the head with its big slump.

HEARING COCHAIR MULLOY: Dr. McKinnon, my understanding is there are international rules that govern this behavior. The International Monetary Fund has rules that you're not supposed to be intervening one way in currency markets to keep an undervalued currency.

So it's not like this is a national decision. There are international rules, and China is a member of that organization. Dr. McKinnon, you’ve spent a lot of time talking about the deleterious impact on China.

We've been out in this country, and I don't know whether you see the deleterious impact that's going on in this country. There's an excellent article I would refer to you in the August 14 edition of Business Week called "A Trade War Right Here at Home," describing the small manufacturers in this country who are being driven out of business and the multinationals who are moving more and more of their production and technology to China and they like it the way it's going. So there's a struggle going on in that area.

We have to advise the Congress and make some judgment on what we should say about the exchange rate issue. So let me just put this one out to Dr. Bergsten and Dr. Setser and I know what you're going to say, Dr. McKinnon.

Dr. Bergsten, you recommend strongly that we don't just let the Chinese manage this gradual appreciation, but that we ask for a pretty significant 30 percent movement, bingo, as a way to handle this problem, and otherwise there will be more capital going in to take advantage of the appreciating yuan, I understand.

Dr. Setser, I'd be interested after Dr. Bergsten speaks, what's your view on the correct way that we should be pushing to get this problem resolved and then Dr. McKinnon, if you have any views on why the Chinese are not violating their IMF obligations, I'd be interested in that.

Dr. Bergsten.

DR. BERGSTEN: My preferred course would be a large one-shot revaluation, and it would counter McKinnon's fear of setting up expectations of further appreciations and therefore affecting interest-rate differentials. I don't think that will happen.

DR. McKINNON: It already has happened with a small appreciation.

DR. BERGSTEN: The renminbi has gotten weaker, Ron, because it's ridden the dollar down for the last five years. DR. McKINNON: The interest rate--

DR. BERGSTEN: The renminbi has gotten weaker on a weighted average basis--regardless of what the Chinese have done vis-à-vis the dollar with their minuscule 3 percent appreciation of the last 12 months. The renminbi has gotten weaker and intensified the problem I'm talking about.

So what I would like to see the Chinese do is a series of annual appreciations as much as they feel they could stand, 5, 6, 8 percent a year, do something substantial in that direction quickly, and treat it as a down payment on a series of steps coming over the next few years. There would be some effect on capital inflow. So they might have to tighten the capital controls on the inflow side during the interim adjustment period.

But I regard that as a less bad solution than letting the imbalances keep building. Brad Setser made a very important point. The U.S. current account deficit is going to keep rising.

HEARING COCHAIR MULLOY: Yes.

DR. BERGSTEN: The Chinese surplus is going to keep rising. The U.S.-China bilateral position, which is now over $200 billion is going to keep rising because the import/export ratio is six to one. It's going to be a bigger source of political tension and protectionist backlash in the United States.

My real fear is that the trading system could crack because the United States followed by Europe, will come down heavily on China. Imagine if the U.S. economy slows down over the next year or two, unemployment starts rising again. Our global current account deficit is a trillion dollars. Our bilateral deficit with China is rising toward $300 billion or more. Give me a prediction on U.S. trade policy.

HEARING COCHAIR MULLOY: Yes.

DR. BERGSTEN: I don't think that's a rosy scenario.

HEARING COCHAIR MULLOY: Going into an election year.

DR. BERGSTEN: If the outcome of the election is one way rather than another, it might exacerbate the problem I'm talking about. The trading system could very well crack, and just to note, as I did in a recent piece in the Post about the new Secretary of the Treasury, two of his illustrious predecessors, Jim Baker and John Connelly, (both in Republican administrations) came into almost identical situations with huge and growing external imbalances and protectionist pressures and took strong initiatives to head it off, which included big changes in exchange rates.

HEARING COCHAIR MULLOY: By the way, that's the New York Times, August 6 article, "Paulson Reinforces His Reach."

DR. BERGSTEN: No.

HEARING COCHAIR MULLOY: Dr. Setser.

DR. BERGSTEN: No, not mine.

HEARING COCHAIR MULLOY: No, but you're quoted in this article.

DR. BERGSTEN: Yes.

HEARING COCHAIR MULLOY: Yes. Dr. Setser.

DR. SETSER: I basically agree with Dr. Bergsten's policy recommendations.

HEARING COCHAIR MULLOY: You do.

DR. SETSER: I do. I agree with his argument that a gradual appreciation is the most we can hope for. I think there is a theoretical case for a big one step revaluation, but I think China has let its own internal economy evolve in such a way that it's hard to change course that rapidly. It's bigger than an aircraft carrier.

HEARING COCHAIR MULLOY: That would be better for us. But you're saying they probably won't do it?

DR. SETSER: They almost certainly won't do it. I think what is important is a clear path for nominal appreciation. I would like to see Chinese inflation rates rise above U.S. inflation rates to have a faster real appreciation than you get in the nominal appreciation. I agree with Dr. Bergsten that, during this period, capital controls will likely need to be tightened in order to discourage those kinds of capital. Why should China give international speculators, myself and my clients included, a free one-way bet on the renminbi?

During this period, China needs to take a series of policy steps to stimulate domestic consumption. The scenario Fred painted, a trillion dollar account deficit, a $300 billion U.S. bilateral deficit, a slowing U.S. economy, that is likely the scenario we face next year.

HEARING COCHAIR MULLOY: Good. Dr. McKinnon, any problem with what they recommended, and does China violate its IMF obligations carrying on the way it's doing?

DR. McKINNON: Fred mentioned the minuscule three percent appreciation of the renminbi against the dollar, not against everything else since August 21, 2005. Now, three percent is the first-order impact when interest rates are 5.25 in the U.S. and two in China. So that three percent, then, is the differential between the two.

If you have a series of well-telegraphed, six percent, seven percent appreciations every year, then this will drive Chinese interest rates to zero. You might say, well, we're going to impose capital controls to prevent the flood of short-term capital that would come in.

That would be very upsetting to all the people who testified in your Panel II, who are all representing American financial institutions who want the capital controls relaxed so they can play in China freely and unrestricted.

But then with the lag, once interest rates go first, then the price level in China will begin to fall. The rate of CPI inflation, year over year, is just one percent at the present time, so it doesn't take much to throw it into an actual fall.

DR. BERGSTEN: What Ron said about the inflation differentials is very important. He extolled the virtue of China having decoupled from U.S. inflation and running substantially lower inflation than the United States, and he's right on that. But, remember, when China's inflation rate is less than U.S. inflation, that's like a further nominal depreciation of the renminbi. That's increasing their competitiveness even more.

So the value of the currency should rise just to offset the further improvement in their competitive position from the inflation differentials.

HEARING COCHAIR MULLOY: I want to thank this panel very much for the very spirited discussion and your contribution to our thinking. I would hope Dr. McKinnon, you'll submit for the record that question about whether China is violating its IMF obligations. That would be very helpful on your views on that.[8]

Thank you very much to this panel. We'll take a five minute break and then we'll begin our last panel.

[Whereupon, a short break was taken.]

PANEL IV: THE MACROECONOMIC IMPACT OF CHINESE FINANCIAL POLICIES ON THE UNITED STATES

CHAIRMAN WORTZEL: Dr. Morici and Dr. Swagel take your places and we'll start with the last panel.

I asked a question in the last panel about the impact of China's financial policies on the United States. Not what can we best advise China to do with its economy, but what is the impact on the United

[8] Click here to read Dr. Ronald McKinnon's subsequent response submitted for the record.

States of China's financial system and monetary policies? That is the subject of your panel. We have a distinguished panel to provide that, "The Macroeconomic Impact of Chinese Financial Policies on the United States."

We have with us Dr. Peter Morici, who is a Professor of International Business at the University of Maryland. He served as the Director of Economics at the U.S. International Trade Commission. He received his Ph.D. in Economics from the State University of New York at Albany, and taught at Augsburg College in Minneapolis and the University of Maine. He serves on the Reuters macroeconomic forecasting panel, and he's the author of 18 books and monographs.

Dr. James Dorn is the Vice President for Academic Affairs and the editor of the Cato Journal at the Cato Institute. He's also Director of Cato's Annual Monetary Conference. He served on the White House Commission on Presidential Scholars and has lectured in Estonia, Germany, Hong Kong, Russia and Switzerland. He has been a Visiting Scholar in Prague and at Fudan University in Shanghai. He's also Professor of Economics at Towson University in Maryland. His Ph.D. in Economics is from the University of Virginia.

The third panelist is Dr. Phillip Swagel. Dr. Swagel joined the American Enterprise Institute after two years as the Chief of Staff at the White House Council of Economic Advisors. He also served as Senior Economist at the Council and a Visiting Professor at Northwestern University. He's been an economist at the Federal Reserve Board, and in the International Monetary Fund.

We have a highly qualified panel and we look forward to your testimony. To remind you, each of you has seven minutes for oral testimony. Your written testimony will go in the record in full form, and then each of the commissioners will have five minutes to ask questions.

Dr. Morici, would you lead off?

DR. PETER MORICI, PROFESSOR ROBERT H. SMITH SCHOOL OF BUSINESS, UNIVERSITY OF MARYLAND, COLLEGE PARK, MD

DR. MORICI: Sure. In the late 1970s, China began a process of economic reform and opening to foreign investment, along with gradual privatization and a diminished role for state-owned enterprises. Since the mid-'90s, the exchange rate has been a central element of China's development strategy.

On December 31, 1993, the yuan was trading at 5.8 per dollar. On January 1, it was trading at 8.7, and since that time, it has been more or less managed. Its value a year later was about 8.28, and it stayed there until last summer. You know the history since then. It has slightly appreciated; factoring in inflation, it has hardly appreciated at all.

This has given Chinese goods an enormous subsidy, which comes to about 25 percent of the value of exports. Let me explain. To maintain the value of the yuan, China intervenes in foreign exchange markets. It buys dollars, sells yuan, and those purchases come to more than $200 billion a year, nine percent of China's GDP, and 25 percent of China's exports.

If you want to know why American manufacturing is not competitive, then close down America's state and local governments or perhaps our public schools and put that money on the back of Chevrolets and I assure you the world will tow them away in great quantity. That is exactly what is going on in China, and anyone that tells you that anything different is going on in China is denying some of the most basic things my very expensive education in economics has taught me.

One of those is that prices matter. If you make something very cheap, people will buy it. This process, and you've heard all about it, all the machinations, has enormous consequences for the United States.

As background, please remember that the last ten years have been a profound period of technologic change in the West and throughout the world; therefore, the growth potential of the U.S. economy is enormous.

China has been accomplishing ten percent growth. You may say, well, gee, they're a developing country; this ought to be happening. In the United States, when we were a developing country and it ought to be happening, it was around six percent between the Civil War and World War I, when we were basically opening up the west and having a similar experience.

The difference has been in China, exchange rate manipulation, which has given it more than its share of growth. Also the fact that we have this very profound technological change going on permits us to do all manner of things, much more efficiently than we ever did before except perhaps run a university. Yes, we are a medieval institution, but that's the subject for another day.

These dollar purchases have very profound effects inside the United States. The Chinese don't sit on this money. They don't just buy these greenbacks. They turn them into bonds. They hold them in depository accounts at the Federal Reserve and that drives down long-term rates.

By driving down long-term rates, mortgages are cheaper and Americans to invest more in the housing market, experience very appreciated values and do not save much.

The low U.S. savings rate is not something that is fundamental to American character. It is something that has evolved over time, and it is a manifestation of what goes on in the housing market because your income is not just what this Commission pays you. Your income is what this Commission pays you plus the change in the value of the assets that you own, and many of you sit on property that is rapidly escalating in value, partially because of its scarcity, being close to Washington, but also partially because of very low mortgage rates, and easy access to capital on the part of banks, which is facilitated by this process of the Chinese buying the bonds.

It causes us to under invest in manufacturing. We've lost three million manufacturing jobs over the last five years. If this recovery was anything like any other recovery, we would have gotten back two million of those jobs.

The upshot of that is we very much under invest in the process of making things because the Chinese give things to us so cheaply. So we're under investing in one area, over investing in another. We have a distorted capital market. Property values are distorted in China because of this, and property values are distorted here because of this.

American companies are making big profits, but they don't invest. Instead, they're buying back their stock. Why are they buying back their stock? They don't see domestic market growth. Going forward, the domestic market isn't growing very rapidly.

The U.S. economy is probably $300 billion smaller this year because of this process. If we had a fairly valued exchange rate, that would come to about $2,000 per worker, but longer term, it has even more important consequences. We're shifting resources out of industries that have much higher productivity into those that have much lower productivity.

Making import competing products and exportables has a higher labor productivity level by about 50 percent. Also, those industries undertake much more R&D, and by depriving them of markets, we're reducing U.S. investments in R&D capital. That probably reduces the U.S. growth rate by one percent a year.

Now, think about it. This has been going on for 20 years between the Japanese and the Chinese. If that hadn't happened, the U.S. economy would be $2.6 trillion larger than it is today. This is a $13 trillion economy. Think about what that would mean--in terms of tax revenues, the size of the budget deficit, whether Gray Davis would still be governor of California. California would not have had the tax revenue problems it had.

All manner of problems would not be so acute if we weren't growing in such an anemic fashion. So it does distort capital markets. It reduces U.S. growth. It deprives American workers of good-paying jobs and then there's the debt. The debt--everything is just fine. I wish Mr. McKinnon was here because I would like him to tell me--

CHAIRMAN WORTZEL: Behind you.

DR. MORICI: Mr. McKinnon, I would like him to tell me how my son is going to pay off that debt. I have a 15-year-old boy and by next year, it's going to be $6 billion. So everything is not just fine. Thank you.

[The statement follows:]

**Prepared Statement of Dr. Peter Morici, Professor
Robert H. Smith School of Business, University of Maryland,
College Park, MD**

Since economic reforms began in the late 1970s, China has enjoyed dramatic growth and modernization. Important structural changes have included a much greater role for town and village enterprises, private businesses and foreign-invested enterprises, and a smaller, though still major, role for large state-owned enterprises. Exports, in particular exports to the United States, have played a key role in driving growth.

Like many developing economies, China has employed a variety of trade barriers and industrial policies to steer investment and ensure the rapid modernization of domestic industries, for example, in the auto and steel sectors.

As in Japan and other Asian countries, monetary authorities have intervened in foreign exchange markets, consistently buying dollars, U.S. Treasury securities and other reserve currency assets, to maintain an undervalued currency.

Chinese monetary authorities purchase more than $200 billion in foreign, mostly U.S., currency and securities or about 9 percent of Chinese GDP and 25 percent of its exports. The resulting subsidy on exports distorts global trade by boosting Chinese exports and stunting Chinese imports, and contributes importantly to the large U.S. trade deficit.

Given rapid productivity growth and foreign investments in China, we would expect the dollar value of the Chinese currency to rise with its development progress. However, in 1995, the Chinese government began pegging the yuan at 8.28 per dollar.

In July 2005, China adjusted this peg to 8.11 and announced the yuan would be aligned to a basket of currencies. However the yuan still tracks the dollar quite closely, with little day-to-day variation, and is currently trading at about 7.97.

Since 1995, the U.S. trade deficit with China has grown from $34 billion to $202 billion in 2005. The overall U.S. current account deficit has grown from $113 billion to nearly $791 billion. In contrast, when China was granted most-favored-nation status by the Congress in 1980, the U.S. bilateral trade and global current accounts were in surplus at $2.1 billion and $2.3 billion, respectively.

Consequently, reduced sales and layoffs in U.S. import-competing industries caused by Chinese competition have not been matched by increased sales and new jobs in U.S. export industries at the scale a market driven outcome would require. The free trade benefits of higher income and consumption to the U.S. economy have been frustrated by currency market intervention.

Consequences for the U.S. Capital Markets and Economy

Massive foreign government purchases of U.S. securities affect both U.S. capital markets and trade flows.

In capital markets, these purchases reduce long term interest rates and provide the mortgage and credit card industries with funds to provide first mortgages, home equity loans and other forms of credit to U.S. consumers at very favorable interest rates and terms. In turn, this is one of several factors that have driven up U.S. home values, and caused nominal household savings rates to become negative. I say "nominal" household savings rates, because, factoring in unrealized capital gains, many households do not feel as though they are dissaving.

At the same time, foreign government purchases of U.S. securities sustain the value of the dollar against the yuan and other Asia currencies, reducing sales and precipitating layoffs in U.S. import-competing and exports industries. This deprives the U.S. economy of many of the benefits of free trade.

In a nutshell, increased trade with China and other Asian economies should shift U.S. employment from import-competing to export industries. Since export industries create more value added per employee and undertake more R&D than import-competing industries, this process would be expected to immediately raise U.S incomes and consumption and boost long-term productivity and GDP growth. These are the essential gains from specialization and comparative advantage increased trade should create.

Instead, growing trade deficits with China and other Asian economies have shifted U.S. employment from import-competing and export industries to nontradable service producing activities. Import-competing and export industries create about 50 percent more value added per employee, and spend more than three times as much R&D per dollar of value added, than the private business sector as a whole. By reducing investments in R&D, an econometric model constructed for the Economic Strategy Institute[*] indicates the overvalued dollar and resulting trade deficits are reducing U.S. economic growth by at least one percentage point a year - or about 25 percent of potential GDP growth. China accounts for about half of this lost growth.

Importantly, this one percentage point of growth has not been lost for just one year. The trade deficit has been taxing growth for most of the last two decades, and the cumulative consequences are enormous. Had foreign currency-market intervention and large trade deficits not robbed this growth, U.S. GDP would likely be at least 10 percent greater and perhaps 20 percent greater, than it is today. GDP and tax revenues would be higher, and other things remaining the same, the federal budget deficit would be smaller.

Individual industries are particularly hard hit. Since 2000, U.S. manufacturing has shed about 3 million jobs. Judging from past business cycles, it should have regained about 2 million of those during this recovery. Trade deficits were likely responsible for the loss of 2 million manufacturing jobs, and productivity growth the other 1 million.

Financing Trade Deficits

Finally, these mounting deficits have to be financed. For example, in the first quarter of 2006, U.S. investments abroad were $333.9 billion, while foreigners invested $491.5 billion in the United States. Of that latter total, only $33.3 billion or 6.8 percent was direct investment in U.S. productive assets. Most of the remaining capital inflows were foreign purchases of Treasury securities, corporate bonds, bank accounts, currency, and other paper assets. Essentially, in the first quarter, Americans borrowed more than $400 to consume 6.4 percent more than they produced.

Foreign governments loaned Americans $75 billion or 2.3 percent of GDP. That well exceeded net household borrowing to finance homes, cars, gasoline, and other consumer goods. The Chinese and other governments are essentially bankrolling the U.S. consumer.

The cumulative effects of this borrowing are frightening. The total external debt now exceeds $5 trillion and will likely exceed $6 trillion by the end of 2006. That will come to about $20,000 for each American, and at 5 percent interest, $1000 per person.

Revaluing the Yuan

Regarding Chinese options, several arguments have been made against letting the yuan rise to a value that balances its external trade but the underpinnings of these arguments are questionable.

It is true that permitting the yuan to rise 30 or 40 percent would impose difficult adjustments on Chinese state-owned enterprises, disrupt Chinese labor markets, and further stress the balance sheets of Chinese banks. However, adjustments of these kinds will only be larger if the yuan is revalued two or five years from now. To avoid such adjustments and sustain its current development model, China will have to purchase ever-larger amounts of dollars, and transfer ever-larger amounts of what it makes to U.S. consumers. Can that be sustained indefinitely?

A revaluation of the yuan would cause a productivity burst in China, wiping out the competitive gains for U.S. import-competing and exporting business. However, this would not be large enough to wipe out completely the competitive effects of yuan revaluation. Moreover, to the extent that a 30 or 40 percent jump in the dollar value of the yuan did not wipe out China's trade surplus and the excess demand for yuan in currency markets persisted, the dollar value of the yuan could be further adjusted without imposing additional hardships. Productivity gains in China would cushion inflationary effects all around, and Chinese living standards would likely increase by fifty percent or more.

The U.S. is dependent on Chinese and Japanese official purchases of Treasury securities (currency market intervention) to finance its federal budget deficit. However, absent this intervention, the exchange rate for the dollar and trade deficits would be lower, and GDP and tax revenue would be higher. To the extent additional tax revenue did not close the federal financing gap, the Fed could purchase additional Treasury securities to maintain interest rates - something it routinely does to expand and regulate the money supply. Instead of the Chinese and Japanese monetary authorities purchasing Treasury securities, the Fed could make those purchases.

*Peter Morici, *The Trade Deficit: Where Does It Come From and What Does It Do?* (Washington, DC: Economic Strategy Institute, 1998).

CHAIRMAN WORTZEL: Thank you. Dr. Dorn.

STATEMENT OF JAMES A. DORN, VICE PRESIDENT FOR ACADEMIC AFFAIRS, CATO INSTITUTE, WASHINGTON, D.C.

DR. DORN: Yes, thank you. I was just up in Buffalo, New York for vacation and was visiting my 97-year-old Irish aunt. I told her I had to cut my vacation short because I had to testify before the U.S.-China Commission and she said, What did you do wrong?" Hopefully I didn't do anything wrong.

Mr. Chairman and members of the Commission, thank you for this opportunity to discuss China's financial system and monetary policy, their impact on the United States, and the relationship between China's financial system and domestic Chinese politics.

These are complex issues and I will only touch the surface today. But I hope to address the core ideas and offer some policy recommendations consistent with the liberal international economic order, which I believe is essential to U.S. economic security and China's peaceful development.

Let me begin by briefly addressing the four questions you asked members of this panel to consider. First, is the present equilibrium sustainable? That is, are we in a new Bretton Woods era? Or do we need a new Plaza-Louvre Agreement to manage adjustment?

The present equilibrium is an equilibrium only in the sense of a status quo. In an economic sense, it is a disequilibrium due to financial repression in China and government profligacy in the United States. The status quo is sustainable only to the extent that China and the rest of the world are willing to accumulate dollar assets to finance our twin deficits.

We may be in a new Bretton Woods era in the sense that China and other Asian countries peg their currencies to the dollar as a key reserve currency, but the analogy to the original Bretton Woods system is misplaced. There is no golden anchor in the present system of fiat monies, and private capital flows and floating exchange rates have fundamentally changed the nature of the global financial architecture.

The International Monetary Fund has been searching for a new identity since the collapse of the Bretton Woods system of 'fixed but adjustable' exchange rates in the fall of 1971 when the United States closed the gold window and suspended convertibility.

The Mexican peso crisis in 1994-95 and the Asian currency crises in 1997-98 resulted in large part because of excessive domestic monetary growth and pegged exchange rate systems in the crisis countries.

Since that time, many emerging market countries have adopted inflation targeting and floating exchange rates. Trying to form a new IMF-led system of managed exchange rates with central bank intervention would be a step backward rather than forward.

We do not need a new Plaza-Louvre Agreement to manage global imbalances. Just as the negotiations approach to trade liberalization gets bogged down in global bureaucracy, government-led coordination of exchange rates is apt to fair no better.

There are many more players today than in the 1980s when China was only a minor player. A surer route to successful adjustment is for each country to focus on monetary stability, reduce the size and scope of government, and expand markets.

International agreements are difficult to enforce and no one really knows what the correct array of exchange rates should be. Millions of decentralized traders in the foreign exchange markets are much better at discovering relative prices than government officials, who are prone to protect special interest groups. Indeed, the United States, for example, wants the yuan to float, but only in one direction.

Let me turn to the second question: What are the chances for an orderly versus disorderly adjustment? And what are the implications of each for the U.S. capital markets?

If China continues to open its capital markets and to make its exchange rate regime more flexible, it will eventually be able to use monetary policy to achieve long-run price stability. At present, the People's Bank of China must buy up dollars--that is, supply renminbi--to peg the RMB to the dollar, and then withdraw the excess liquidity by selling securities primarily to state-owned banks.

This sterilization process puts upward pressure on interest rates which if allowed to increase would attract additional capital inflows. The People's Bank of China thus has an incentive under the current system to control interest rates and to rely on administrative means to manage money and credit growth.

But the longer the system persists, the larger the People's Bank of China's foreign exchange reserves become, and the more pressure there is for an appreciation of the RMB/dollar rate.

The July 21, 2005 revaluation and a number of changes in the institutional setting to establish new mechanisms for market makers and hedging operations are steps in the right direction. Financial liberalization, however, will take time, and China will move at her own pace. The United States should be patient and realistic.

Most of the costs of China's undervalued currency are borne by the Chinese people. Placing prohibitively high tariffs on Chinese goods until Beijing allows the RMB/dollar rate to appreciate substantially is not a realistic option. It would unjustly tax American consumers, not correct the overall U.S. current account deficit or even our bilateral trade deficit with China, and it would slow liberalization.

Adjustment requires that China not only allow greater flexibility in the exchange rate, but also allow the Chinese people to freely convert their RMB into whatever currencies or assets they choose. Capital freedom is an important human right and would help undermine the Chinese Communist Party's monopoly on power by strengthening private property rights.

A more liberal international economic order is a more flexible one based upon market-determined prices, sound money, and the rule of law. We should help China move in that direction--not by threats, but by example.

The U.S. government should begin by reducing its excessive spending and removing onerous taxes on savings and investment. An orderly adjustment based on market-liberal principles would help ease the cost to the global economy and to the United States in particular. Keeping our markets open sends an important signal to the rest of the world, and getting our fiscal house in order by trimming the size of government and by real tax reform would show that we mean business.

Reverting to protectionism on the other hand would have a negative impact on the global financial system and adjustment would be slower and more costly.

The third question raises two important issues, namely: What is the likelihood that China will seek to diversify its foreign currency holdings and what would be the consequences?

The composition of China's foreign exchange reserves is a state secret, but a reasonable estimate is that about 80 percent of China's $941 billion worth of reserves are held in dollar denominated assets, especially U.S. government bonds.

Any sizable one-off revaluation of the RMB/dollar rate would impose heavy losses on China. Other Asian central banks would also suffer losses on their dollar reserves as the trade-weighted value of the dollar fell. No one wants to be the last to diversify out of dollars. If the Euro becomes more desirable as a reserve currency, the People's Bank of China and other Asian central banks can be expected to hold more euros and fewer dollars in their portfolios.

The future of the dollar will be precarious if the United States continues to run large budget deficits and fails to address its huge unfunded liabilities.

Foreign central banks would not wait for doomsday. They would begin to diversify now. Markets are ruled by expectations so it is crucial for the United States to begin taking positive steps to get its own house in order and to reaffirm its commitment to economic liberalization.

May I have one more minute?

CHAIRMAN WORTZEL: Go right ahead and finish that fourth point.

DR. DORN: Thank you. For its part, China can help restore global balances by moving toward a more flexible exchange rate regime and liberalizing capital outflows so that there would be less pressure by the People's Bank of China to accumulate foreign reserves.

Delaying adjustment means faster accumulation of reserves, greater risk of capital losses by holding dollar assets, and a stronger incentive to diversify.

If China does begin to increase the pace of diversification, and the United States does not effectively resolve its long-term fiscal imbalance, the result would be higher U.S. interest rates, crowding out of private investment, and a decline in stock prices.

Finally, let me briefly address the fourth question: What are the likely consequences of failure to address global current account imbalances?

The most serious consequence in my mind of not addressing the global current account imbalances would be the persistence of market socialism in China and creeping socialism in the United States.

The failure to address global imbalances means a failure to accept economic liberalism. China needs to move forward--toward a market-liberal order--which means China needs a rule of law that protects persons and property: and the United States needs to resist protectionism and reduce the size and scope of government.

While it is useful to consider the macroeconomic impact of Chinese financial policies on the United States, it is important to remember that China is still a relatively small economy. What matters most for the U.S. economy is to pursue sound monetary and fiscal policies at home. If we follow such policies and maintain an open trading system, U.S. prosperity will continue.

Thank you.

[The statement follows:]

Prepared Statement of James A. Dorn, Vice President for Academic Affairs, CATO Institute, Washington, D.C.[9]

CHAIRMAN WORTZEL: Thank you very much. Dr. Swagel.

STATEMENT OF DR. PHILLIP SWAGEL, RESIDENT SCHOLAR AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, D.C.

DR. SWAGEL: Thank you very much. In talking about the impact of Chinese policies on the U.S. economy, I'll focus on

[9] Click here to read the prepared statement of Dr. James A. Dorn

sustainability as well. My sense is that concerns about the impact of China on the United States, are in these sharp changes in the situation which naturally leads to a discussion of sustainability.

Two aspects of the present economic situation seem to me to be particularly relevant in talking about sustainability. Those have been discussed in this panel and in the last panel: the low rate of U.S. saving and the associated external balance and excessively stimulative Chinese monetary policy and the correspondingly weak exchange value of the Chinese currency, the yuan.

To understand the risks and the appropriate policies relating to these unsustainable situations, it's useful to focus on underlying causes. I'll go through these in turn. The low U.S. saving is the root cause of the trade deficit. That's an accounting identity that, of course, the current account balance, of which the trade deficit is most of the balance, is saving minus investment. The data in the Bureau of Economic Analysis' national income accounts show that investment has rebounded well since about the middle of 2003.

National saving, however, remains quite low. Personal and public saving are negative. The research literature in economics, in refereed journals, does a very good job at explaining the low rate of personal saving in the United States, and essentially a large part of this is related to the increase in asset prices.

Essentially the rising wealth of American households means that American households do not need to save out of the flow of their income. Essentially, your Schwab account is doing great so you don't need to save anything out of your paycheck.

There's lots of fancy econometrics that show that, but in a sense it's reassuring to say that we well understand why Americans aren't saving.

On the public saving side, I think we can all understand as well, we have a moderate deficit now by historical standards, but of course very large deficits in the future.

This means that we're funding U.S. investment by inflows of capital, including importantly from China. These inflows of capital support growth in the United States and support job creation, but lead to a build-up of foreign liabilities. It would be better if the U.S. saved more.

In terms of Chinese monetary policy, I think I agree with most of the previous speakers that Chinese monetary policy is excessively expansionary, involving an overly weak exchange rate and excess liquidity growth. The way I see it--this relates to a question in the last panel—is: what's the motivation?

My sense is that the Chinese government is buying an insurance policy to keep growth strong and ensure social peace. I think this insurance policy is too expensive for them; it's unnecessary. And now it's moving into outright harmful territory.

It's expensive. In a sense, they're giving a gift to the United States of more than $50 billion a year by overpaying for U.S. Treasury bonds, plus they're selling products to U.S. families for lower prices than they need to. Now, obviously, some U.S. families are hurt by the import competition. On the whole, looking at it overall, there are the usual gains from the trade, that U.S. families benefit from low-priced goods, and I think it's important to note that the poorest of U.S. families are probably the ones who benefit the most, again, overall.

The Chinese insurance policy. I think Chinese growth could easily remain strong with domestic consumption rather than exports, and it's harmful in that, as previous panelists have noted, the weak exchange rate and loose monetary policy have given rise to overbuilding in the Chinese export sector and now threatens to give rise to inflation and financial sector instability.

The Chinese have been trying to head off these problems in an ad hoc and ineffective fashion. Allowing for a stronger currency and appreciation of the yuan is a clear way to help rebalance the Chinese economy. And of course, over time, the Chinese government has other problems. They have to rebuild the social safety net and prepare for demographic change: again, these are things that have been noted in previous panels.

In terms of rebalancing the global economy, a change in the Chinese economy would help the United States as well. It would allow us to maintain strong growth led by exports rather than domestic consumption. And in that regard, it would help as well if China would pay for U.S. services' imports such as movies and music instead of stealing them.

To talk briefly about the impact on the U.S. economy, of course, the weak currency and Chinese monetary policy harms import-competing U.S. industries, while firms that export to China gain from strong growth in China. Chinese monetary policy and the associated weak currency helps the United States through lower interest rates and low prices of U.S. imports.

Some people worry that an intentional sell-off of dollar assets or, as the Commission staff asked about, a diversification of Chinese assets could hurt the United States, set off higher interest rates and slower U.S. growth.

Of course, China would hurt itself by taking a capital loss. I'm going to mix two metaphors here. The capital loss is really baked into the cake already in China. They've overpaid for assets, perhaps 25 percent too much. If they would mark their balance sheet to market, they've already taken a loss. To switch the metaphor, they're in a hole. It's time for them to stop digging. Allowing for the exchange rate appreciation on their part is the obvious policy to do so.

In terms of the U.S. policy, the appropriate focus is on policies to boost national saving. Again, looking at the fiscal outlook, entitlement spending is the largest item going forward on the public sector balance sheet. And tax reform in the United States would be useful to remove the bias against saving and to increase personal saving in the U.S.

And lastly, I'll note that these are policies that the United States and China should do on their own. An international effort might be helpful if it helps create political dynamic to undertake these difficult changes. In the meantime, though, it would be useful to continue to work through the existing fora, such as the IMF and bilateral technical assistance from the United States to China.

Thank you very much.

[The statement follows:]

Prepared Statement of Dr. Phillip Swagel, Resident Scholar American Enterprise Institute, Washington, D.C.[10]

Panel IV: Discussion, Questions and Answers

CHAIRMAN WORTZEL: Thank you very much. I'd like to lead off with two questions. First, if China revalued, why wouldn't U.S. investments simply flow into some other place like Vietnam, for instance, where it can also take advantage of low labor rates? Currently, China's currency is not a convertible, would making the currency convertible affect that exchange rate problem?

DR. MORICI: With regard to the first question, if other countries maintain their current exchange rates, our trade deficit would shift to them.

CHAIRMAN WORTZEL: Right.

DR. MORICI: However, they would then have very large current account surpluses, which would require them to buy dollars and sell their currency, and through some kind of domestic machination accomplish a transfer of wealth of comparable size from the people that make those goods and services to us. Right now, the Chinese people right don't get nine percent of what they make, and for the people on the export platforms, it is a much higher percentage because it's coming

[10] Click here to read the prepared statement of Dr. Phillip Swagel

out of their hides.

It is doubtful in my mind that would be politically possible in places like Thailand, Vietnam and so forth. It would have to happen in many places because many places would have to add up to accomplish that. If China had a convertible currency? Economists are wonderful at assuming away problems using partial equilibrium analysis to make macroeconomic conclusions. There are studies running around saying, well, gee, the trade deficit is just going to shift to other places. They're going to sell us the stuff. Because they assume other exchange rates aren't going to change.

They don't tell you what they have to do to assume that. I could play for the Detroit Pistons next year if I were 6'6" and 37 years old, and if I assume that, it works. That's how that works.

Making the yuan a convertible currency would not matter if the Chinese government chose to have an exchange rate of 7.9. All they would have to do is keep buying dollars. Also, the fact that they don't have a convertible currency or that their banking system is in the pail has nothing to do with this.

If they have a problem with their banking system and need a pegged exchange rate, fine, mark it to five tomorrow morning--Fred's solution. But I don't think Fred's solution is enough because that supposes that anybody in this room or anyone in the world knows what the market price for the yuan should be, and remember the exchange rate is a price. That is the most important message I want to leave with this group: the exchange rate is a price. It's the most fundamental price in a market economy, and to say it doesn't matter is to say that prices don't matter, but we don't know what that price should be.

After the Bretton Woods system came apart, the yen rose 65 percent in value, but it wasn't enough because it continued to be managed. The end of the day is we don't know what the real value of the yuan should be. I estimate it's probably 40 to 50 percent undervalued. However, if you turned around and did that tomorrow morning, a lot of unharvested productivity gains would be realized because an undervalued yuan is a form of protectionism.

Chinese manufacturing has been benefiting from protectionism so they'll get more productive again, and the trade will probably get worse again. The Chinese currency is going to have to rise a lot, an awful lot, to fix this problem, but don't be fooled. It's not going to happen because the Chinese don’t think it's in their interests; it's not in their interests to make this change.

They're going to keep on playing this game with us as long as we sit here and talk about it and not really do anything about it.

DR. DORN: Yes. I'd like to just address that briefly. If there were an appreciation of the yuan, in the short term, it may actually lead to a larger surplus with the United States because a lot of the trade is processed trade, and China relies heavily on imported component parts, which would now be cheaper.

Jonathan Anderson from UBS just made this argument. I think there is something to it. As far as diverting trade, if we placed a large tariff on Chinese imports, that may well divert trade to other Asian countries. And that means that it wouldn't change the overall U.S. current account very much, and I think that's probably right.

As far as currency convertibility goes, I look upon it as part of capital freedom and a human right. Individuals ought to be free to convert their currency into whatever other currency or assets they want to. That's part of an individual’s private property rights.

So the lack of full convertibility is one ill effect of the Chinese communist system. Now, Russia just made their currency fully convertible, and I think that's a step in the right direction.

DR. SWAGEL: Just to add another word on convertibility, allowing convertibility and eventually open capital flows would mean that Chinese families would eventually invest in other countries, just as American families through financial services firms invest in China. Over time this could actually lead to a weaker yuan as the enormous pent-up saving that is now forced to go into Chinese banks goes all over the world.

In the future, if one could imagine Chinese families taking their money to the U.S. and letting American financial services firms, the best in the world, invest it for them including perhaps back in China.

CHAIRMAN WORTZEL: Thank you very much. Commissioner Mulloy.

HEARING COCHAIR MULLOY: Thank you, Mr. Chairman. First, I want to note that for the record, Dr. Francis Warnock, Associate Professor at the Darden School of Business at the University of Virginia, could not be here, but he submitted testimony for the record called "The Impact of East Asian Reserves' Accumulation on U.S. Interest Rates."

This will be in the record and will go on our Web site, but I urge colleagues to look at this. One of the points he makes is that foreigners now own 52 percent of U.S. Treasury bonds. So what he points out is that's a whole new amount of money flowing out of the country to pay the interest on these Treasury bonds which are now held by foreign interests, and this is accumulating, increasing quite rapidly, their holdings of U.S. Treasury bonds.

In March of 2000, it was 35 percent and now it's 51.7 percent or 52 percent in June of 2006. So I urge people to take a look at that.

Dr. Morici, you heard the debate before--we're looking for a recommendation on how to get China to appreciate its currency. Do you take the Fred Bergsten 30, 35 percent or the more nuanced view of ten percent a year be pushing them? What should we recommend to the Congress?

DR. MORICI: We can't recommend to the Congress that the Chinese government change the value of the yuan.

HEARING COCHAIR MULLOY: Yes.

DR. MORICI: So you're really asking two different questions.

HEARING COCHAIR MULLOY: Okay.

DR. MORICI: What should the Chinese do and how do we motivate them?

HEARING COCHAIR MULLOY: What should we be advocating?

DR. MORICI: Okay.

HEARING COCHAIR MULLOY: What should our government be advocating?

DR. MORICI: I think that we should advocate both a jump in the value of the yuan and then permitting it to gradually increase.

HEARING COCHAIR MULLOY: How much of a jump?

DR. MORICI: I like 30 percent. That's nice.

HEARING COCHAIR MULLOY: 30 percent. You would go that--

DR. MORICI: That's a nice number.

HEARING COCHAIR MULLOY: --and then let it--

DR. MORICI: The point is, is that we want them to continue to let it rise in value until they no longer have to intervene in foreign exchange markets.

HEARING COCHAIR MULLOY: Yes.

DR. MORICI: The marker should not be the exchange rate. Rather it should be the level of intervention. But the intervention has to go away and then if it falls in value because of the various factors that could come into play, fine.

Think about what that would mean. If they didn't intervene, we would not have this large capital account surplus because not only does the Chinese intervene but other governments intervened as well because they can't let their currencies rise in value lest they lose their markets here.

So if we didn't have this large inflow of capital, we wouldn't have this large trade deficit. We wouldn't be building up debt and the imbalances would go away. In the end, we have to remember that the global imbalances in savings is in large part being motivated by a conscious act of government. It is not the spontaneous behavior of private actors.

HEARING COCHAIR MULLOY: Let me add to that because Dr. Warnock discusses that on page four of his testimony. He says about the reserve accumulation, which you get from intervening and managing your currency to keep it under priced, he says this is--China together with Japan, Hong Kong, Taiwan, and Korea--at the risk of offending someone, I call this group East Asia.

He says if China breaks its tight link to the dollar, others will follow suit. So he says the linchpin is you get China to move and then you can get these others to move.

DR. MORICI: If they don't move, then they have to buy the $200 billion China is buying now. If the trade deficit shifts, so does the burden of buying those dollars and selling whatever currency they have, the domestic inflation that would follow, and so forth.

One must remember that economists are very fond of applying models of developed countries to China. Where else in the world could you print that many yuan and not have more inflation than we have? See, that's why they say, oh, Chinese are going to have inflation, they're going to have problems. They're growing at 11 percent a year. They're getting people off the farm that they want to get off the farm, and they have inflation at two percent. If I were the Chinese Communist Party, I'd keep on doing this as long as the mugs in Washington let me.

HEARING COCHAIR MULLOY: Dr. Swagel, are the Chinese violating any of their IMF obligations in your view by this massive intervention in currency markets to keep an undervalued currency?

DR. SWAGEL: I was formerly an IMF staff. Whether they're precisely violating the IMF obligations is probably a technical and legal question that I'm not really equipped to answer.

HEARING COCHAIR MULLOY: Is there a prohibition that the IMF puts out about one-way intervention in currency markets to keep an undervalued currency?

DR. SWAGEL: Not that I know of. The IMF wants an appropriate monetary policy, but there are fixed exchange rates in the world. The United States when we were developing in the 1800s ran a fixed exchange rate. I would say it's not so much a legal question as a policy question. The Chinese are doing something that's inappropriate. It's bad for them; it's bad for us.

HEARING COCHAIR MULLOY: Okay. You say it's inappropriate?

DR. SWAGEL: Yes. Even if it's legal or illegal, it's a bad idea.

HEARING COCHAIR MULLOY: Okay.

DR. MORICI: One of the things to remember is--

HEARING COCHAIR MULLOY: It's harmful to us.

DR. SWAGEL: It's harmful.

HEARING COCHAIR MULLOY: And them.

DR. SWAGEL: It's harmful to them. To us it has mixed effects. In the short run, there's a sense in which they're giving us a gift. They're hurting some parts of our economy and helping others. In the long run, it would be better for us and for them for them to change.

HEARING COCHAIR MULLOY: Peter?

DR. MORICI: Yes, one of the things to remember is the IMF system, the old Bretton Woods system had mechanisms that would put pressure on countries with overvalued currency to make the adjustments but not countries with undervalued currencies.

Remember the franc crisis and the pound crisis. Those were the result of the fact that the Germans had a currency that was undervalued. But there was nothing implicit in that system that would force the Germans to revalue. In the end, the French and the British had to devalue their currencies. We can't devalue by the way the system is set up. That's the problem.

So the IMF is not set up to deal with a problem like this. Now, the GATT, the principles of the GATT require that countries don't use their currencies as a mechanism of protectionism or to subsidize exports. You want a recommendation to the Congress for something we can do--if you recommend a 30 percent tariff, they'll say you've been listening to that crazy guy at College Park.

But a very reasonable thing is the Hunter-Ryan bill, because it basically says the currency is a subsidy, and if you're harmed by this subsidy, you should be able to countervail.

It is not protectionism to deal with someone else's protectionism. To not do so is unilateral disarmament.

HEARING COCHAIR MULLOY: Thank you very much.

CHAIRMAN WORTZEL: Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Yes, I may be stealing Commissioner Donnelly's questions. Let's assume once again that, as we talked about with the other panel, the Chinese do nothing that we ask them to do. They just keep going along with the policy that they currently have with respect to export-led growth and undervaluing the currency and so forth.

Then let's assume that we do get our fiscal house in order. Let's assume that we have more influence over that, and we deal with entitlements and we deal with savings and so on and so forth. How would that affect the Chinese economy and how would that in turn affect--let's say we unilaterally take care of our own savings problem and the Chinese don't do anything on the surplus side of things. How does that affect them and how does that affect us? That's for all of you.

DR. DORN: I'd like to relate that to something which was just mentioned as well. In restoring trade balances, what matters is the real exchange rate, and the real exchange rate consists of two components: a nominal exchange rate and relative price levels in the United States and China.

So if China’s real exchange rate is undervalued and has to appreciate, which most economists believe to be the case, the PRC can either do it by domestic inflation, changing relative price levels, or by letting the nominal exchange rate appreciate. Zhou Xiaochuan, who heads the central bank, and other leading reformers have all agreed that the best route to the rebalancing is by basically allowing the nominal exchange rate to appreciate, and that's what they're doing now--but they're doing it at a very, very slow pace.

But in doing so, without allowing capital account convertibility, the bank faces a real problem with domestic monetary policy. Capital inflows are coming in through the trade account as well as the capital account. Most of these dollars that are coming into China are sold to the People’s Bank of China. The Bank prints new currency to buy those dollars up and then sells bills to sterilize those inflows, but it's very difficult to do.

The yuan appreciated in real terms between 1994 and 2002 by about 30 percent--basically because of inflation. So what I would argue is that China has got a real incentive to let the nominal RMB/dollar exchange rate appreciate over time to avoid dangerous inflation, which would lead to a lot of social problems.

As far as the United States goes, we should reduce our marginal tax rates to increase savings. If we get our own house in order, and we use domestic monetary policy to keep inflation low, our economy will prosper, which means it will also be a very good investment destination for foreigners.

Running a trade deficit is not necessarily a bad thing. It depends how that deficit is financed. If it's financed by China buying U.S. government bonds and soothe funds are not used for real investment, that's one thing.

But if it's used for real investment, that's another thing. So I think we have to address that problem.

COMMISSIONER BLUMENTHAL: Let me just assume for a second here that we're saving more and we're consuming less. Chinese export-led growth then has a problem; right? Because we're the greatest importers.

DR. DORN: Right. If we reduce consumption, it will also reduce the U.S. trade deficit with China.

COMMISSIONER BLUMENTHAL: In other words, if we take these actions that we can take, it's going to have effect on the Chinese model of growth?

DR. SWAGEL: Exactly. It will essentially put their model under even greater pressure. What Dr. Dorn said is exactly right. Their monetary policy will have to work even harder. Essentially, the way they've avoided inflation so far with this huge liquidity growth is to stuff excess liquidity into the moral equivalent of Chinese families' pillows by forcing Chinese families to put this liquidity into banks. There is basically nowhere else Chinese families can save besides banks.

Some of that saving is squandered. Some of it goes into very low-paying Chinese government bonds. If your scenario took place, I suspect that ultimately it would lead them to move even more rapidly toward a currency appreciation just because they couldn't keep control of their inflation, they couldn't keep control of their economy.

So I would think it would be good for us and it would be good for them in a sense of forcing them to do what they should be doing now.

DR. MORICI: I have to ask, and for you, being a good professor, how would you increase U.S. savings? The only really predictable way of increasing U.S. savings is either tax people more or to spend less: that would reduce the deficit.

So let's make it so that we're all happy right now, and we'll say we'll spend less. If you look at the size of the budget deficit, one of the questions I'm always getting from reporters on the phone, Peter, we have a large budget deficit, doesn't that cause the trade deficit?

The budget deficit is good for what--about $350 billion. And the trade deficit is about $700 billion. How could a $350 billion budget deficit cause a trade deficit that large? The answer is that a $350 billion budget deficit can contribute perhaps $350 billion to the trade deficit. But it can't account for all of it.

If we reduced the federal budget deficit and as a society our net savings was higher, some of the trade deficit and the problem that we have would go away, but not all of them. But some of it would go away.

The trade deficit would be, say, three percent of GDP, not six percent, to answer your question, so that would be better. That would put the Chinese growth model under some pressure. They would accomplish a lower rate of growth. Would China still be a problem? Would we still be borrowing money from China? Yes, we would be, but we have a one-time correction and then we'd continue as we are with the trade deficit again growing and growing and growing.

COMMISSIONER BLUMENTHAL: Thank you.

CHAIRMAN WORTZEL: Commissioner Donnelly. Same question?

COMMISSIONER DONNELLY: No, no, no. I did have a backup plan. And that is to begin to give an observation on the interrelated nature of political and economic reform when it comes to China, not only in the question of exchange rates, but, as we heard from earlier panelists, on financial reform more broadly speaking. If we are asking for reform from China, we are putting their political system under a lot more stress, so if we simply advocate economic measures, what the Chinese hear is political turbulence and turmoil on their side.

So in order to be fully responsive to the nature of the problem, it's not good enough, I would suggest, whatever one's economic, preferred economic reforms are, and not that they're bad in and of themselves, but to simply sit here and say we know what's best for China, it actually may be best for the Chinese people, but it's not necessarily what the Chinese Communist Party views as best for the party.

So the question for, particularly for those, you know, people with experience in government as well as academic experience is how can American policy be shaped and also accounting for the fact that the continuance of a single party state in power is not necessarily fully consistent with American political principles, how to navigate between these contradictory impulses?

Again, doesn't it leave our economic prescriptions for China wanting in the sense that they're inevitably likely to at least cause the Party to think that its hold on power is threatened, so how to link political and economic reform in China?

DR. SWAGEL: I can take a first cut at this. My reading of Chinese history is that political instability in China, certainly in the last two centuries, but even going back further, has often been linked to economic problems--inflation, lack of public spending, lack of tax revenue, famine. These are things that are social, of course, but also have economic roots.

So in a sense, you can go in two directions. One is to reassure China that they can keep growing and there won't be instability if they just change your policies in the way that I think most people agree they should.

The other, of course, is if we do right our ship, as the previous question from Dan Blumenthal got at, that would put pressure on China, and if they don't move--if they're hesitant to undertake the right policies, one could imagine a situation in which they do have economic problems: their banking system comes under pressure, they start to have actual inflation that the divide between the rural areas and the urban areas grows deeper and leads to more rioting.

And so one could imagine a situation in which our doing the right thing leads to social and political instability in China. Is that a good thing or a bad thing? That's not an economic issue.

DR. DORN: Yes. I'd like to just also say a few words on that. If China wants to become a world-class financial center, it's going to eventually have to have capital convertibility. They know that. They recognize that. On the other hand, they recognize also that given the current lack of well-defined property rights and rule of law in China now, if they completely open their capital markets, there would be a big capital outflow and the banking system would be in very precarious shape.

So it's going to be a step-by-step process to normalize China's balance of payments. It doesn't make any sense for China, which is a capital-poor country, to be a net exporter of capital. That's what they're doing now because the exports of capital come through buying huge amounts of U.S. government bonds.

So the problem in China is basically a huge misallocation of capital, and I guess Kellee Tsai and other people probably mentioned that this morning. So the private sector is starved of capital to a large extent because most of the capital goes to the state-owned banks who funnel it to state-owned enterprises.

COMMISSIONER DONNELLY: Not to be contentious, but it doesn't make sense unless you fear economic liberalism as a halfway house to political change.

DR. DORN: That's right. It's not so much an economic problem in China. They know what to do. The reformers know what to do. A friend of mine, Fan Gang, was just appointed to the Monetary Policy Committee. They've got some very fine economists there and they understand market economics. It's not an economic problem so much as a political problem because the financial sector is the last vestige of central planning.

So the question is, will the Communist Party give up its monopoly on power to a certain extent to liberalize the capital markets? I don't really know the answer to that question. But I believe that if the U.S. moves in the right direction by getting our own house in order, global economic forces will move China further toward a market-liberal order.

DR. MORICI: I think you've really raised the $64 question. And that is the connection between economics and politics. We have been increasingly approaching this problem as an economic problem in our public discourse from all sides, and in reality there are two things to remember. First, this process does not affect the Chinese economy the way it would affect a normal developing economy or a developed economy because of its legacy of state central planning that actually worked at some level.

For example, why aren't they having all this inflation? Fred answered the question. Every time a worker moves from the farm to the city, productivity goes up 16 to one. With that kind of productivity growth, they don't have to give them all the money. They can keep the nine percent to subsidize the exports.

Second, the Chinese government doesn’t make decisions based solely on economics. It balances political considerations as does our government--unfortunately, that's one of the reasons we have a trade deficit. We have a budget deficit that's too large, and we also have an oil import policy that makes not the best sense. Again, a subject for another day, but we shouldn't be importing as much oil as we do, and there are reasonable things we could do about that. But we don't.

Likewise, the Chinese government doesn't see the economic consequences of this set of arrangements the way this panel does. And it has different political considerations. One of them is they don't want free elections any time soon because they don't want to let go of power. China is an autocracy in which relationships to the Communist Party are roadways to wealth.

It is the families that are connected to the Party that do best in the process of reform. So if they let go of power, it's like any ruling elite. I don't think we should take the view that if we do the right things, they will see it in their interests to do the right things. In some ways what we need to recognize is we have to threaten them, and I don't mean by waving our fingers and being threatening, but create a situation where not moving is threatening to their internal stability so they have to move to sustain their hold on power.

CHAIRMAN WORTZEL: On that note, I want to thank all of you gentlemen for being here and the panelists for the entire day as well. I also want to acknowledge members of our staff--Melanie Graham, Don Padou, Paul Magnusson and Erik Pederson--in helping to put this hearing together and the background that we used for it together. Thank you very much.

[Whereupon, at 4:20 p.m., the hearing was adjourned.]

ADDITIONAL STATEMENTS SUBMITTED FOR THE RECORD

"The Impact of East Asian Reserves Accumulation on U.S. Foreign Interest Rates." Francis E. Warnock, Associate Professor, Darden Business School, University of Virginia, Charlottesville, Virginia[11]

[11] Click here to read the statement submitted for the record by Francis E. Warnock.